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August 25, 2004

**VIACOM**

**VIA ELECTRONIC FILING**

Marlene H. Dortch, Secretary
Federal Communications Commission
445 12th Street, S.W.
Washington, DC 20554

**Re: MB Docket No. 04-227,** ***Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, Notice of Inquiry***

Dear Ms. Dortch:

Viacom hereby submits in the above-referenced proceeding its comments and reply comments in MB Docket No. 04-207, *À La Carte and Themed Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite System.* The comments are responsive to requests for input in the *Notice of Inquiry* on the potential impact of packaging video programming services on an à la carte or mini-tier basis. In particular, the comments demonstrate that a mandatory à la carte or themed tiering regime would both drive up consumer prices dramatically and cause a sharp decrease in the diversity and quality of program services.

Please direct any inquiries regarding this matter to the undersigned.

Respectfully submitted,

/s/

Anne Lucey

**Before the**
**FEDERAL COMMUNICATIONS COMMISSION**
**Washington, D.C. 20554**

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| In the Matter of:<br><br>À La Carte and Themed Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems | <br><br>Docket No. MB 04-207 |

# COMMENTS OF VIACOM


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**COMMENTS OF VIACOM**

## I. INTRODUCTION AND SUMMARY

Viacom hereby submits its comments in response to the FCC's May 25, 2004 Public Notice in the above-referenced proceeding.[1] The Notice seeks input on a number of questions regarding the potential economic, public policy, and legal implications of à la carte and so-called "themed" tier programming and pricing. In particular, it invites comment on regulatory proposals that would require, to one degree or another, the "unbundling" of cable and satellite television offerings. As explained herein, such mandatory regimes would substantially and needlessly disrupt the existing program network business model that has brought unprecedented diversity to the American television viewing audience.

Today's consumers have access to literally hundreds of program networks, which appeal to an incredibly diverse range of tastes and interests, at monthly subscription rates that represent a substantial bargain when compared with other forms of popular entertainment. These benefits are the product of a system that is heavily reliant on broad-based program tiers. The existing

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[1] *See Media Bureau Action Comment Requested on A La Carte and Themed Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems*, Public Notice, DA 04-1454 (May 25, 2004).

system assures that consumers will continue to receive a wide variety of general and specialized services by providing those services with a realistic opportunity to compete for the distribution levels they need in order to remain viable.

A government-imposed à la carte or themed tiering mandate would throw this well-functioning system into disarray, threatening many of the existing consumer benefits and efficiencies. Both economic analyses and real-world evidence indicate that, overall, consumers would be significantly disadvantaged by unbundling requirements. As explained in the attached analysis of Economists Incorporated, an à la carte regime inevitably would reduce the viewership of individual networks and, consequently, reduce both subscription and advertising revenues. At the same time, mandatory unbundling would force networks to sell their services on a subscriber-by-subscriber basis, thereby triggering a drastic escalation in programmer marketing costs. Indeed, based on the marketing experiences of existing à la carte services, it is estimated that individual networks could incur hundreds of millions of dollars in annual marketing expenses, *just to maintain their existing subscriber levels*.

These adverse economic effects ultimately would be borne by consumers, who would be faced with both a sharp increase in monthly fees and a reduction in the diversity and quality of program offerings. Indeed, for the $40 monthly fee that the average consumer pays today for cable service that includes basic service, equipment, and 46 program services, the à la carte consumer likely would be able to purchase only basic service, one converter box, and fewer than five per-channel offerings. To reassemble on an à la carte basis the entire package of services provided to the average subscriber in today's marketplace, a consumer may have to spend upwards of $200 per month.

The only consumers who conceivably could benefit economically from mandated à la carte are those who subscribe to a mere handful of program services. Those selecting one network would pay, on average, about $24 (including the basic service and converter box), those selecting two would pay about $28, those selecting three would pay approximately $33, and those selecting four around $37. However, even for these select consumers, there is no guarantee that their preferred networks would maintain their current levels of program quality or even would survive the change to an à la carte world.

The adverse impact on programmer costs and revenues that would result from an à la carte mandate also could trigger a "death spiral" effect in the programming marketplace. As an individual network increased its license fees in order to recoup lost revenue and absorb rising costs, and those increased costs were passed on to consumers, more and more subscribers would drop the network, reducing subscription and advertising revenues even further. This chain of effects ultimately could result in the demise of some networks, especially those catering to niche and minority audiences.

Moreover, unbundling would make it far more costly and challenging for consumers to view new content, often forcing them to go through the trouble of signing up and paying for an entire network just to sample a single new program. Such a regulatory scheme thus would impair the ease of access of all Americans to new ideas and alternative viewpoints, thereby directly threatening the Commission's important and longstanding diversity objectives. Similar consequences would flow from mandated themed tiering obligations, as well as a mixed à la carte/tiering regime.

In addition, à la carte regulations—and certainly any form of mandatory "themed" tiering—would be riddled with First Amendment problems. Regulations requiring programming to be packaged according to content-specific themes would be intrinsically content-based and, accordingly, presumptively invalid. At a minimum, content-neutral regulations could not pass constitutional muster unless they could be proven to be "narrowly tailored" to a "substantial government interest" under the intermediate scrutiny test. Given the consumer benefits inherent in the current system, the obvious shortcomings of government-mandated unbundling, and the existence of blocking mechanisms that already address concerns about unwanted programming, it is highly unlikely that such obligations could satisfy this heightened standard of First Amendment review.

## II. VIACOM'S INTEREST IN THIS PROCEEDING

Viacom has interests in subscription program networks that cover a wide array of entertainment and informational genres and that appeal to audiences in a broad range of demographic categories. Through its MTV Networks division, for example, the company provides a substantial number of specialized music and entertainment networks, targeted to kids, young adults, and adults, including Nickelodeon/Nick at Nite, which is targeted to children and families; MTV: Music Television, MTV2, VH1: Music First, and CMT: Country Music Television, each of which specializes in music and music-based programming; Comedy Central, dedicated to comedy programming; Spike TV, the first network specifically designed for men; and TV Land, which is devoted to classic television programming. Responding to the demand for children's educational programming is MTV Networks' Noggin service, the only commercial-free educational channel dedicated to pre-schoolers 12 hours a day. (The N, which is paired with Noggin during the evening and overnight hours, focuses on the interests of teenagers and pre-teens). Through its BET subsidiary, Viacom provides Black Entertainment Television, the largest national cable network devoted to African-American interests; BET JAZZ, the country's only 24-hour network devoted to jazz music; as well as BET Gospel and

BET Hip-Hop, two recently launched digital networks. MTV Español and VH Uno cater to the interests of the Latino community. And Showtime Networks Inc. ("Showtime Networks") offers "premium" networks Showtime, The Movie Channel, and Flix that supply audiences with around-the-clock access to movies and original programming.

Like most subscription video programming services, the vast majority of Viacom's networks are distributed to consumers via broad-based programming tiers. With the exception of Showtime Networks' premium channels, Viacom's networks generally are not offered to U.S. consumers on an à la carte basis, but rather are pre-packaged by cable and satellite operators with competing program services. As explained herein, the continued success and diversity of Viacom's program offerings—and its ability to create new and diverse program services for consumers—is largely dependent on maintaining the current program packaging and distribution model.

## III. THE EXISTING SYSTEM OF PROGRAM PACKAGING AND DISTRIBUTION IS FUNCTIONING EXCEPTIONALLY WELL

In the U.S., the vast majority of MVPD services are provided via pre-packaged basic, expanded basic, and digital programming tiers. Largely because of this system of "bundling," the programming marketplace has grown substantially in recent years, and represents a significant and particularly well-functioning segment of the economy. American consumers today have access to a wide and dynamic range of program services at a price that is relatively modest in comparison to other forms of popular entertainment.[2] Moreover, there is no basis for

[2] The breadth of program options available to American consumers is considerably greater than in other countries. *See, e.g.*, Michael Hennessy, President and CEO, Canadian Cable Television Association, Remarks before Washington Metropolitan Cable Club (June 29, 2004) (attached to *ex parte* presentation of NCTA, MB Docket No. 04-207 (June 30, 2004)) (noting that "Canadians are very envious of the choice and diversity available to American consumers").

concern that this system is being dictated by the "forced" bundling of program networks in the wholesale negotiations between programmers and MVPDs.

### A. <u>The Current System Has Produced a Vibrant and Diverse Marketplace and Is Highly Efficient for Consumers</u>

As Economists Incorporated explains in its Report, bundling is a common practice in a variety of retail markets because it is highly efficient and cost-effective.[3] By spreading production and distribution costs over a large number of customers, bundling can greatly improve consumer welfare by lowering the price of goods and services. Bundled products also are appealing to consumers. Pre-packaging enables consumers to purchase various distinct components in a single transaction, thus saving them the time and resources that would be required to assemble discrete pieces into a finished product.

Consider, for example, the bundled offering of another advertising-based communications medium: the local newspaper. A newspaper consists of numerous sections, each of which may appeal to different readers. The publisher bundles the sections, though, to minimize distribution costs and to provide a single outlet for a wide diversity of information. A uniformly bundled newspaper allows the publisher to place the same type of news rack on every corner and to deliver the same paper to every household. Bundling also enhances the value of the newspaper to advertisers, who gain access to all purchasers of the paper by placing a single ad. These savings and efficiencies are passed on to the consumer, who purchases a quality product at a modest price. Further, consumers do not waste time inserting change in multiple news racks or determining which sections or articles are worth purchasing that day. Rather, they receive diverse content in one simple transaction. Moreover, purchasing newspapers in complete

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[3] Bruce M. Owen and John M. Gale, Economists Incorporated, *Cable Networks: Bundling, Unbundling, and the Costs of Intervention*, at 12-14 (July 15, 2004) (Attachment 1) ("EI Report").

editions gives readers immediate and convenient access to writers or articles they might not otherwise have known existed and to sections of the paper that may appeal to them only on an occasional basis.

In the context of multichannel video programming, bundling has played a similar role in developing a rich, diverse, and efficient marketplace. Under the existing programming distribution system, the number of non-broadcast program networks available to consumers has skyrocketed in recent years. Whereas there were approximately 106 national, non-broadcast program networks available for carriage by MVPDs as of year-end 1994, that number had jumped to 339 by June 2003.[4] In addition, a large number of regional and local networks have been launched over the last decade. As of June 2003, there were at least 84 regional and local non-broadcast networks, compared to approximately 35 such networks a decade earlier.[5]

The remarkable growth in the number of program networks has led to a concomitant increase in program diversity and specialization. Channels devoted to general interest topics are now supplemented by a plethora of networks catering to highly specialized consumer interests, which fulfill audience demand for ever more targeted programming. In the realm of sports, for example, ESPN is now supplemented by such niche-oriented options as the Golf Channel, The Martial Arts Network, Speedvision, and the Outdoor Life Network.[6] The multitude of networks catering to specific minority and ethnic interests includes BET, Celtic Vision, ART (Arab Radio & Television), and National Jewish Television. Educational and documentary options range from the Science Channel, to History Channel International, to Discovery Wings, while the host

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4 *Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, 19 FCC Rcd 1606, 1617 (2004) ("*10th Annual Competition Report*").

5 *Id*. at Table C-3. Of these networks, 37 are local and regional news networks. *See id*. at 1617.

6 *10th Annual Competition Report* at Tables C-1 & C-4.

of networks catering to lifestyle interests includes the Food Network, the Home & Garden Network, and the Travel Channel.[7] As the Commission recently observed with respect to the current environment, consumers are now "served by literally hundreds of networks serving all conceivable interests."[8]

Networks generally rely on a dual revenue stream of advertising revenues and subscription fees.[9] Subscriber revenues are derived by multiplying a network's average per-subscriber rate by its total number of subscribers. The advertising revenue that an individual programmer is able to garner is principally driven by the number of viewers that can readily sample the network, or its "subscriber base," as well as the number of viewers watching the service at any given time. As the Government Accounting Office (GAO) explained in a recent report on the cable industry, "[t]o receive the maximum revenue from advertisers, cable networks strive to be on cable operators' most widely distributed tiers" because "advertisers will pay more to place an advertisement on a network that will be viewed, *or have the potential to be viewed*, by the greatest number of people."[10] In Viacom's experience, a network usually needs a subscriber base of approximately 50 million, which represents about half of the country's households, to serve as effective advertising vehicles.[11] From the perspective of national

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[7] *Id*.

[8] *2002 Biennial Regulatory Review—Review of the Commission's Broadcast Ownership Rules and Other Rules Adopted Pursuant to Section 202 of the Telecommunications Act of 1996, Report and Order and Notice of Proposed Rulemaking*, 18 FCC Rcd 13620, 13634, 13665 (2003) ("*2002 Biennial Review Order*"). The FCC further noted that today's subscribers to multichannel services have, "[a]t any given moment," access to "scores of TV networks devoted to movies, dramatic series, sports, news and educational programming both for adults and children. In short, niche programming to satisfy almost any of our citizens' diverse taste." *Id*. at 13935.

[9] *See* EI Report at 7.

[10] Government Accounting Office, *Issues Related to Competition and Subscriber Rates in the Cable Television Industry*, Highlights of GAO-04-8, Telecommunications, at 35 (October 2003) ("GAO Report") (emphasis added).

[11] *See* EI Report at 31.

advertisers, a network below this threshold does not have sufficient reach to impact a substantial portion of the U.S. market. In addition, the ratings of individual networks provided by Nielsen Media Research become more stable and reliable when a network reaches a base of around 50 million subscribers.[12]

The packaging of networks into program tiers expands each network's subscriber base (and its potential for being viewed), as well as its actual viewership. Such bundling will enhance a network's subscription revenues and its appeal to advertisers, thus helping to ensure that it will have an opportunity to generate sufficient revenue to invest in quality programming and become or remain economically viable. Channel surfers are a particularly important part of this equation. Not only are these viewers valued by advertisers, they are critical to building the future viewership base for individual networks. When channels are provided as part of a broader package, audiences have the opportunity to become familiar with a greater variety of program services, without having to make an additional monetary commitment. Indeed, according to a recent study commissioned by the Cable and Telecommunications Association for Marketing, viewers who start watching a new channel are most likely to find it by "just flipping through the channels."[13] Overall, 45 percent of the study's respondents indicated that they found new channels in this manner, and the percentage rises to 49 percent in digital cable homes.[14] Without this access to potential viewers, many networks would not even have a hope of reaching the penetration levels they need to achieve adequate ratings and advertising revenue.

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12 *See id*.

13 Lieberman Research Worldwide, Prepared for CTAM, *Tracking the Evolving Use of Television and Its Content*, at 15 (March 2004).

14 *Id.* While channel flipping was the most common method for finding new channels by a significant margin, the next three most common methods were: (1) starting to watch a specific show on the channel (cited by 30 percent of respondents); (2) TV advertising on another channel (cited by 27 percent of respondents); (3) and word-of-mouth from friends or relatives (cited by 26 percent of respondents). *Id*.

In addition to offering consumers an incredible diversity of program services, the current program packaging system also has proved to be highly efficient and economical for consumers. Compared to most other forms of popular entertainment, MVPD services offer a tremendous bargain. For example, the average subscription price for cable service—currently about $40 per month—is less than the cost of taking a family of four to a night at the movies or to a professional sporting event.[15] Moreover, the provision of program packages saves consumers the extensive time and energy it would take to personally research and select individual program networks. Program packaging also affords consumers immediate access to a wide range of programming and viewpoints they may wish to view only on an occasional basis, without having to go through the trouble of ordering and subscribing to the relevant network in advance. In the event that consumers find certain programming offered within a bundle to be objectionable, they can either block such channels or make use of the V-chip. Either mechanism will prevent unwanted programming from being carried into individual subscriber homes.

As explained below, government imposition of an à la carte or tiering mandate unnecessarily would jeopardize the efficiencies and public interest benefits inherent in the current system, causing a simultaneous increase in prices and decrease in program quality and diversity.

### B. <u>There Is No Basis for Concern that the Current Marketplace Is Being Dictated by Forced Bundling at the Wholesale Level</u>

In its Report, EI examines the question of whether, through "bundled" sales, program suppliers "force" MVPDs to purchase their full line-ups of program services. It is probably true, all other things being equal, that such providers would generally prefer to sell all of their

[15] *See Cable Offers Good Value to Consumers*, National Cable & Telecommunications Association (April 2004), at http://www.ncta.com/pdf_files/IssueBriefs/CablePrices.pdf_files (last visited July 13, 2004).

program services to each MVPD with the capacity to carry them. But the available evidence indicates that even the largest providers fall short of achieving this result.

To examine this issue, EI conducted an analysis of 2,455 cable systems, representing approximately 80 percent of cable subscribers, that reported carrying a minimum of 35 satellite-delivered program services on their basic and expanded basic tiers.[16] The study revealed that *none* of the cable systems carried 100 percent of Viacom's networks, and only 13 percent of the systems took 75 percent or more. For five of the nine program providers studied, no more than a quarter of the cable systems took all of the program services offered.[17] No more than half of the cable systems took all the services offered by the remaining four programmers included in the study.[18] Moreover, the data most likely understate the diversity of program bundles purchased, since even cable systems that take the same number of networks offered by a specific programmer do not necessarily take the same networks.

The EI Report clearly contradicts the allegation that suppliers of programming can "force" MVPDs to carry all of a supplier's offerings. Indeed, it confirms that systems can and routinely do choose to carry some but not all of the networks offered by a given supplier. Even where networks sell their services in packages, EI found that "network suppliers sell their networks in many different combinations and on a stand-alone basis," which demonstrates that MVPDs are not compelled to purchase programming under rigid pre-packaged plans.[19] In addition, the programmer (as a participant in a competitive marketplace) "must offer a price for

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16 EI Report at 16-19.

17 In addition to Viacom, this group included Cablevision, Discovery, Disney, and Time Warner. *See id.* at 18, Table 1.

18 These programmers consisted of A&E, Comcast, Fox, and Lifetime. *See id*.

19 EI Report at 18.

the bundle that is no greater than the sum of the competitive prices of the individual networks, compensating their customers for low-value networks, by, in effect, lowering the price of their most popular networks."[20]

A number of questions in the Notice appear to implicitly link wholesale bundling (the sale of network services to MVPDs) with retail bundling (the resale of such services to subscribers by MVPDs). But there is no necessary connection between those two very different applications of the bundling concept. In fact, regardless of whether an MVPD purchases network carriage rights on a bundled or unbundled basis, this "would not change the MVPD's decision about whether to offer those networks to subscribers bundled or à la carte."[21]

The Notice also invites comment on whether program suppliers "force" MVPDs to place particular networks on particular tiers. It may be that suppliers generally favor the placement of all of their advertising-supported networks on the tier that can be accessed by the largest number of subscribers. But even the largest and most successful suppliers must frequently settle for carriage on far less widely-viewed digital tiers for their new or less "proven" network offerings. Accordingly, there is simply no basis for concern that the structure of the current marketplace is dictated by program sales practices at the wholesale level.

## IV. THE IMPOSITION OF AN À LA CARTE REGIME WOULD THREATEN THE FINANCIAL UNDERPINNINGS OF THE PROGRAM MARKETPLACE

EI demonstrates in its analysis that requiring program packages to be unbundled at the retail level likely would have a series of adverse economic consequences for programmers and, most importantly, for consumers. As a starting point, EI points out that, because the current tiering practices are part of a highly complex economic marketplace, it is impossible to predict or

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20 *Id.* at 3.

21 *Id.* at 19.

quantify all of the consequences that would result from regulation in this area.[22] But it is clear that government-mandated unbundling would represent a radical departure from the broad-based tiering approach that has been adopted as the prevailing industry norm and would jeopardize many of the public benefits achieved under the current system. These consequences are most clearly illustrated in the context of a strictly à la carte retail marketplace.[23] As explained in Section VI below, however, the same analysis would apply under a regulatory regime mandating themed or other forms of mini-tiers as well as under a mixed tiering/à la carte system.

First, the marketing costs incurred by programmers would jump significantly under an à la carte regime. Because networks would be forced to market their services to each individual subscriber in an à la carte world, the time and resources that programmers would need to devote to marketing efforts would mushroom. Second, the number of subscriptions to individual program networks would fall, causing a decline in existing subscription revenues. At the same time, programmers would lose advertising revenue in an à la carte scheme, because both the actual viewership of an individual network and its subscriber base would decline. Moreover, as EI concludes, these effects are "likely to persist in the long run, and to result in a permanent reduction in aggregate welfare."[24] In the end, these negative consequences would be passed on to consumers in the form of increased prices and decreased choice.

### A. <u>The Costs of Providing Program Services to Consumers Would Increase Substantially Under an À La Carte System</u>

An à la carte system would dramatically raise costs for both program networks and MVPDs. For networks, the reason is obvious: instead of focusing the marketing of their services

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22 *See* EI Report at 7-8.

23 *Id*. at 23.

24 *Id*. at 8.

principally on a relatively small universe of MVPDs, program providers also would have to market their services directly to millions of subscribers. As demonstrated by data from Showtime Networks, which has operated in the à la carte world since its launch in the 1970s, these individualized marketing efforts could entail expenditures in the hundreds of millions of dollars per network, per year. The viewing public would be far better off if such extraordinary sums could continue to be invested in programming and production, rather than in marketing.

Because a program provider would no longer have guaranteed distribution of its service to subscribers, it would be forced to engage in extensive "transaction marketing" to stimulate retail demand for its services on a consumer-by-consumer basis.[25] These efforts would be in addition to programmers' existing marketing and advertising activities. By extrapolating from the average annual transactional and associated marketing costs per consumer connect for the premium movie cable network category, Showtime Networks examined the costs of these enhanced marketing efforts for networks under a mandatory à la carte regime. First, Showtime calculated that the marketing costs per connect average approximately $11.25 per year for the existing premium movie networks.[26] The costs that networks would face if forced to abruptly shift to an à la carte marketing model likely would be substantially higher, however. Unlike the existing handful of premium networks that currently compete only against one another, networks

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25 "Transaction marketing" is defined as a program of tactics, activities, and resources designed to generate subscriptions to an à la carte network by stimulating consumer demand and influencing consumer choice at the point of sale. These tactics include, but are not limited to, consumer rebates, free previews, promotional offers, telemarketing, direct mail, customer contact personnel (CCP) sales incentives, CCP trainings and awareness tools, and distributor incentives to favorably price, package, and promote the network such as volume and penetration discounts, retail price incentives, and cash marketing support. *See* Showtime Networks Research and Analysis, *The Impact of À La Carte Pricing on Multichannel Video* at 2 (July 2004), EI Report, Appendix C ("Showtime Networks Analysis"). Programmers also would incur the costs of personnel to implement these marketing activities. These costs would be particularly difficult for networks to absorb, as shown in the following sections, in light of reduced subscription and ad revenues.

26 *See* Showtime Networks Analysis at 4; EI Report at 39. The premium movie category currently consists of Showtime Networks Inc. services (Showtime, The Movie Channel, and Flix), Home Box Office, Inc. (HBO, Cinemax), and Starz Encore Group (Starz, Encore).

in a mandatory à la carte environment would be forced to compete against hundreds of other unbundled networks for subscribers. The marketing costs for recently unbundled networks would be further inflated as these networks, unlike already established premium services, would have to scramble to attract initial subscribers. Moreover, most networks would lack the in-house expertise needed to effectuate these marketing changes and, thus, would incur significant start-up costs. Taking these additional factors into consideration, Showtime Networks estimates that non-premium networks could face per-connect marketing expenses of up to $16.90 per year.[27]

Further, to estimate the total annual marketing costs that a network would incur in an à la carte regime, Showtime Networks took into consideration the "churn rate" (the percentage of households per month that discontinue their subscription to a service) that networks likely would experience.[28] The average monthly churn rate for the premium movie network group is approximately 5.9 percent.[29] Assuming networks in an unbundled environment would experience approximately the same churn rate as these premium services, the average number of annual "replacement" connects that a network with 25 million subscribers would need simply to maintain its subscriber base would be about 17.7 million households. With per-connect marketing costs estimated at $16.90, a network of this size would incur $300 million in costs each year *just to retain the same number of subscribers*.[30]

In addition to the increased costs that programmers would incur in an à la carte world are the incremental costs that MVPDs would sustain. As EI explains, MVPDs would have to make

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27 *See* Showtime Networks Analysis at 7; EI Report at 39.

28 A network must replace each subscriber lost per month to churn simply to retain the same number of subscribers.

29 *See* Showtime Networks Analysis at 4.

30 EI Report at 39-40. But even if the costs were only half as much for advertiser-supported networks, they still would be immense—and could have a crippling effect on such networks.

significant technical expenditures in order to implement an à la carte system, including the purchase and installation of additional addressable converters and headend equipment.[31] Furthermore, fulfilling the virtually endless permutations of program network combinations that subscribers could select—and change at will—in an à la carte system would significantly complicate, and thus increase the cost of, subscriber ordering and billing.[32] As the GAO Report found, a substantial number of U.S. households also would have to purchase addressable converter boxes in order to receive programming on an à la carte basis.[33]

Ultimately, EI concludes, consumers, to whom the increased programmer and MVPD costs would be passed, "will also face a probable loss of some existing networks and program services, a reduction in the number of new networks and program services entering the market, a lost option value to view infrequently watched programming on channels no longer subscribed to, and additional equipment costs."[34] As explained next, all of these costs would rise at the same time that revenues from subscriptions and advertising would fall.

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31 *See id*. at 37.

32 The likelihood of increased customer service expenses was recognized by GAO in its recent report on the competitive state of the cable industry. *See* GAO Report at 32.

33 As noted in the Report, some cable operators have reported that less than half of the households they serve have addressable boxes. *See id*. As GAO further noted, conversion to addressable boxes could be "costly" for consumers. *See id*. According to the FCC's 2002 cable rate survey, the average monthly rental price for a digital converter box and remote control is $4.87. *Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992*, 18 FCC Rcd 13284, 13297 (2003) ("*Report on Cable Industry Prices*"). Subscribers with multiple television sets would need multiple converter boxes. The average American television household has about 2.5 televisions, and hence would face an equipment cost of over $12 per month. *See* EI Report at 38.

34 EI Report at 37.

## B. The Penetration Levels, and Thus the Subscription Revenues, of Individual Program Networks Would Decrease Dramatically Under an À La Carte Regime

It is evident that subscription levels to individual networks would decline under an à la carte regime. Although the exact decline in penetration of any given network would be a function of a complex array of factors that cannot be precisely quantified, EI's analysis explains that some broad conclusions can be reached.[35] Simply put, once a price is set for any individual network, some consumers will choose not to receive it. Because subscribers today do not pay a specific price for any of the individual networks offered in existing programming bundles, a separate price would have to be established for each network under an à la carte system. Those subscribers who watch a given network the least intensively as part of a programming bundle would be the ones most likely to opt out. Of course, as the price for a network increases (on account of the increased costs and lower revenues resulting from à la carte regulation), even more subscribers will opt out.[36] In addition to these pricing considerations, it is likely that subscribership to individual networks would be further diminished due to a decrease in consumer awareness, and an increase in confusion, regarding the multitude of programming options available to them in an à la carte environment.

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[35] *See id*. at 24-25. As EI explains, among the factors that would determine declines in subscribership are the price established by MVPDs, whether a network offers general interest or specialized programming, and the existence of alternative networks offering similar programming. *See id*. at 26.

[36] As EI explains in its Report, this effect is demonstrated by the subscription levels to existing premium networks, including Showtime, HBO, and Cinemax, that currently are offered on a per-channel basis. Specifically, existing data from Warren Communications shows that the subscription levels, or "take rates," to each of these networks tends to be lower in markets where MVPDs charge higher prices for the network. For example, 93 percent of subscribers to Showtime currently pay a monthly fee of between $7.00 and $14.00. Depending at least in part on where prices fall within this range, the take rate for Showtime among basic service tier subscribers varies from 9.5 percent to 22.9 percent. Likewise, 93 percent of HBO subscribers pay between $8.00 and $14.00 per month for the service. For each dollar amount in that range, the ratio of HBO subscribers to total basic subscribers varies from a low of 20.2 percent to a high of 23.4 percent. *See* EI Report at 57-59, Appendix B.

That subscription levels to individual networks can be expected to fall sharply in a per-channel regulatory environment is illustrated by the experience of The Disney Channel. Launched as a non-commercial premium, à la carte network in the 1980s,[37] The Disney Channel initially had relatively low subscribership. In the early 1990s, The Disney Channel began seeking carriage on basic service tiers,[38] and since 1999, the network generally has been offered exclusively on basic service tiers. The changes in penetration rates of The Disney Channel over time are telling. In 1989, it had approximately 4.4 million subscribers.[39] By early 1995, when roughly half of Disney subscribers received the channel as part of expanded basic service, the subscribership to the channel had increased to 12.6 million.[40] Moreover, the network had experienced a one-year jump in subscribers of nearly five million, which came "primarily from three cable operators that decided to offer Disney in their packages of channels."[41] This number multiplied over the next several years, and, as of 2003, there were approximately 83 million subscribers.[42] While many factors may have contributed to this surge in subscribers, it is undeniable that the switch to broad-based tiering played the most critical role.

Similarly, HBO—a premium service that spends nearly $1 billion annually on programming, incurs hundreds of millions of dollars in yearly marketing costs, and has a string

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37 *See, e.g.*, Tom Shales, *Mouse-ka Magic: The Disney Channel Thrives on Cable TV*, Washington Post, Dec. 18, 1983, at G1.

38 James Bates, *Company Town: Disney Channel Lets Out A Quiet Roar*, Los Angeles Times, Jan. 24, 1995, at D4 ("*Disney Channel Lets Out A Roar").*

39 Henry Gilgoff, *Manhattan Cable Hopes Disney's Mouse Will Roar*, New York Newsday, June 28, 1989, at 49.

40 *See Disney Channel Lets Out A Roar.*

41 *Id.*

42 Walt Disney Corp., 2003 Annual Report (2004) at http://disney.go.com/corporate/investors/financials/annual/2003/kb/mnc/mnc_dc.html (last visited June 21, 2004).

of highly popular and critically acclaimed original programs—has reached a penetration level of only approximately 28 million subscribers.[43] Most networks, of course, have both less renowned programming and far fewer available resources.

Holding all other factors constant, the loss of subscribers that would occur under an à la carte mandate would reduce the revenues received by programmers under their existing carriage contracts. Indeed, because networks typically are paid by MVPDs on a per-subscriber basis, programmer revenue suffers whenever there is a loss of subscribers. Moreover, as explained below, this result would be compounded by decreased advertising revenue, leaving programmers with little choice but to raise prices and/or decrease quality, and potentially exit from the business.

### C. Programmer Advertising Revenue Would Decrease if Networks Were Provided to Consumers on an À La Carte Basis

Because of the reduced viewership of individual networks in an à la carte environment, advertising revenue also would decline. As noted above, the value of a program service to advertisers is based both on its actual viewership (or ratings) and the number of potential viewers to which it has access at any given time (or subscriber base).[44] Both ratings and reach would suffer in an à la carte world. In addition, national advertisers often have minimum subscriber base requirements. In Viacom's experience, many national advertisers regard a minimum subscriber base of approximately 50 million households as necessary in order to reach a meaningful number of viewers. A switch to an à la carte system likely would lower the

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[43] *See, e.g.*, Julie Salaman, *Will 'Sex and the City' Without the Sex Have Much Appeal?*, The New York Times, June 9, 2004 at 1 (noting HBO has 28 million subscribers); *see also* Showtime Networks Analysis.

[44] *See supra* Section III(A). As GAO noted in its recent study of competitive trends in the cable industry, the cable industry executives interviewed for purposes of the Report indicated that "any movement of networks from the most widely distributed tiers to an à la carte format could result in a reduced amount that advertisers are willing to pay for advertising time because there would be a reduction in the number of viewers available to watch the networks." GAO Report at 35.

subscriber base of many networks below this threshold, thus potentially taking them out of the running for a large segment of national advertising.

The importance that advertisers place on "unduplicated reach" could further reduce the revenue that programmers would receive in an à la carte world.[45] As EI explains in its Report, in order to avoid overlap between viewing audiences, advertisers typically pay a premium for a larger audience. In other words, a ten percent increase in audience size generally produces more than a ten percent increase in advertising revenue, while a comparable reduction in reach likely would have the opposite effect.

The ability of "hit shows" to be discovered and grow audiences also would be adversely affected by an à la carte model, an outcome that could further impact the advertising marketplace. Under the current business model, subscriber access to a wide range of program services is merely a remote control "click" away. Thus, the viewership—and therefore the ad earnings—of networks often grows very quickly when they provide new hit shows.[46] The "hit show" phenomenon is now experienced by niche-oriented networks as well as broad-based services. Just recently, for example, BET achieved the largest audience in its 24-year history for "BET Awards," an annual program which drew 5.7 million viewers—beating the prime-time line-ups of broadcast networks the WB, UPN, and Fox, and rivaling ABC in viewership for the evening.[47]

Under an à la carte system, this process would be disrupted, both because it would take viewers longer to find out about new program offerings and because, once they did, they would

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45 *See* EI Report at 35-36.

46 *See id.* at 36.

47 *See* John Maynard, *CBS Wins by Putting Its Redux in a Row*, The Washington Post, July 8, 2004, at C7.

have to go through the trouble of subscribing to new networks in order to view the hit programs. Just to have the ability to watch a single new program—which they may or may not ultimately find to be appealing—subscribers often would have to take the time to contact a customer service representative, find out the cost and other information regarding the relevant network, and pay a monthly fee to subscribe to it. Many consumers obviously would not want to be bothered with these obstacles.

Because the extent to which programmers rely on advertising revenue differs, the impact of an à la carte mandate on such revenue obviously would vary from network to network.[48] While the drop in advertising revenue may not be proportional to the loss of viewership, it is clear that an à la carte mandate would have a substantial negative impact on this source of programmer revenue.

## V. BECAUSE PROGRAMMERS WOULD BE FORCED TO BOTH RAISE RATES AND CUT BACK ON PROGRAM INVESTMENT, CONSUMERS WOULD BE SEVERELY DISADVANTAGED UNDER AN À LA CARTE SCHEME

Consumers ultimately would bear the burden of the negative economic effects discussed above. In order to recoup the lost revenue and absorb the increased costs that likely would result from government-mandated à la carte, many programmers would raise the license fees charged to MVPDs. These higher rates would be passed directly to consumers.[49] The only other alternatives available to programmers would be to cut back on program production and/or acquisition expenditures, thereby decreasing the quality of their programming, or to cease

[48] Using the estimated 2003 advertising revenue of 107 national basic cable networks, EI shows this variation in its Report. Of the networks included, over a dozen relied on advertising for less than 10 percent of their revenue, while a few relied exclusively on advertising. The median value of advertising as a portion of total revenue was 44 percent. *See* EI Report at 29-30.

[49] As was noted in the recent GAO Report, under an à la carte system, programmers would "become less reliant on advertising revenues and much more reliant on license fees that would likely be passed on to consumers." GAO Report at 35 (emphasis omitted).

providing service entirely. All told, consumers in an à la carte regime would be faced with an increase in per-network subscription prices, a reduction in program quality, the exit of some networks, and limited entry of new networks.[50]

### A. <u>The Prices Charged for Individual Networks Likely Would Rise In Order to Recoup Lost Revenues and Cover Increased Costs</u>

In order to maintain program quality in an à la carte regulatory regime, program services would need to offset declines in subscription fee and advertising revenue, as well as increased marketing expenses, most likely by raising their license fees to MVPDs. This, in turn, likely would lead to increased retail rates for the consumer. EI has constructed a model that illustrates this effect. In reality, programmers most likely would respond to the increased costs and decreased revenue associated with an à la carte mandate in a variety of ways—including through various combinations of price increases and program investment cuts.[51] To make a clear economic analysis possible, however, the EI model assumes that networks would respond solely by increasing their licensing fees. As EI concludes, its calculations "strongly suggest that consumers will end up paying substantially more than they do now for the present collection of cable networks or for any substantial subset of networks."[52]

EI's analysis is based on the 110 cable networks for which Kagan Research provides 2003 data. For each of these networks, EI first assumes the percentage of existing subscribers that would continue to subscribe in an à la carte world, selecting three different retention rates: 10 percent, 20 percent, and 30 percent.[53] EI builds on this model by accounting for decreased

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[50] *See* EI Report at 9.

[51] *See id*. at 43.

[52] *Id*. at 5.

[53] EI Report at 42. As EI explains, this range of retention rates is reasonable, given the current take rates of the existing premium movies services. *See id*. at 42, n. 25.

advertising revenue and increased marketing expenditures. Specifically, EI incorporates three different advertising loss rates for the 110 Kagan-rated networks: 20 percent (or an 80 percent advertising retention rate); 40 percent (or 60 percent retention); and 60 percent (or 40 percent retention).[54] The model also takes into account Showtime's analysis, discussed above, that networks annually would spend an average of $16.90 per subscriber "connection" in order to market its services in a per-channel environment.[55] Based on a monthly churn rate of 5.9 percent, EI has calculated that the programmers included in the model would incur additional monthly marketing expenses of approximately $1.00 per subscriber.[56] EI further assumes that MVPDs uniformly would mark-up wholesale prices by 90 percent.[57]

Using these assumptions, EI estimates à la carte retail prices for each of the 110 networks.[58] For example, starting with the highly optimistic assumptions that networks would retain 30 percent of their existing subscribers and 80 percent of their advertising revenue, the average retail price of a network would be $3.39. If, however, networks retained only ten percent of their existing subscribers and only 40 percent of their advertising revenue, the price would jump to $7.70. In stark comparison, the average retail price of a network today is only $0.38.[59] The analysis thus shows that, under forced unbundling, per-network costs would be between 9 and 20 times greater than they are under the current system.

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54 *See id*. at 42. For purposes of this model, EI assumes that those viewers that continue to subscribe to a network on an à la carte basis were the core viewers when the network was provided as part of a tier and, accordingly, that loss in ad revenue will be lower than actual viewer loss. *See* EI Report at 42.

55 *See supra* Section IV(A).

56 *See* EI Report at 43.

57 *See id*.

58 *See id.* at 43-44.

59 *See* EI Report at 45.

On top of individual license fees, subscribers would incur monthly fees for the basic service tier—which presumably would continue to carry local broadcast signals and PEG channels pursuant to FCC rules—as well as for set-top boxes. These expenses would increase the above monthly fee estimates significantly. Assuming a marketplace in which programmers were able to retain 20 percent of their subscribers and 60 percent of their advertising revenue—the midpoint of the subscriber and advertising retention rates considered in the EI model—the average price of a network would be $4.46 and that of ten networks would be $44.60. Adding the cost of the basic service tier ($14.45) and one converter box ($4.78), the monthly fee to the consumer would rise to $23.69 for one à la carte network and to $63.83 for ten networks.[60] Based on these assumptions, a subscriber would be able to receive only the basic service tier, one converter box, and fewer than five à la carte channels for $40—the price that the average consumer currently pays for cable service consisting of approximately 46 channels.[61] Similarly, to reassemble on an à la carte basis the 46 channels that the average MVPD subscriber receives today, a consumer may have to pay well over $200 per month.

As noted above and in the EI Report, à la carte regulation likely would spark a series of complex reactions in the programming marketplace, not all of which can be precisely mapped out or incorporated into a simple economic model.[62] Although there are many potential permutations to EI's model, it provides a useful illustration of the significant upward pressure

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[60] As EI explains, the FCC found in a 2002 survey that the average price of a cable basic service tier is $14.45, and that of digital converter box was $4.87. *See id.* at 45, n. 31 (*citing Report on Cable Industry Prices*, 18 FCC Rcd at 13292).

[61] *See id*. at 45 (*citing Report on Cable Industry Prices*, 18 FCC Rcd at 13292, 13297).

[62] *See supra* Section IV; EI Report at 7-8.

that an à la carte government mandate would risk imposing on consumer prices.[63] In addition, this upward pressure could have a "death spiral" effect on the programming marketplace: as the license fees charged by an individual network increase in order to recoup lost revenue and absorb rising costs, and as those increased costs are passed on to consumers, more and more subscribers would drop the network, reducing subscription and advertising revenues even further.[64] In the end, these pressures could result in the demise of some networks.

### B. <u>Program Quality and Diversity Would Suffer Under an À La Carte Regime</u>

Faced with declining subscription and advertising revenues that cannot be fully recouped through increased subscription fees, the only remaining choices for networks in an à la carte regime may be to either lessen program quality or to stop providing service entirely. Indeed, because not all networks would be able to sell their services at the inflated prices necessary to recover lost earnings and maintain a viable level of service, "it is reasonable to believe that at least some networks will be forced out of existence" under the impediments of an unbundling mandate.[65]

While an à la carte regime would pose a substantial threat to all networks, those serving specialized or minority interests would be particularly at risk. As explained above, such

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[63] The GAO's recent study of cable rates echoed EI's findings regarding the likely impact on consumer prices, noting in particular that "[i]f cable subscribers were allowed to choose networks on an à la carte basis, the economics of the cable industry could be altered, and, if this were to occur, it is possible that cable rates could actually increase for some consumers." GAO Report at 34.

[64] Moreover, as EI explains, the only way that regulators possibly could ensure that consumer prices would not increase sharply in an à la carte environment would be to regulate rates, a prospect that would thwart the ability of the economic marketplace to function efficiently and enmesh the government in a regulatory quagmire. Indeed, the government would be faced with the hopelessly complex task of pricing each network in a manner that would cover its specific program and other operational costs. An unjustified rollback of these rates, of course, could jeopardize the viability of many programmers. *See* EI Report at 4-5.

[65] *See id*. at 46.

networks rely heavily on the efficiencies provided via the existing bundled system.[66] In order to cultivate viewership and attract sufficient advertising revenue, it is critical for these networks to be provided on a packaged basis. BET's services provide an apt example of the threat that an à la carte mandate could pose to specialized programming. While BET is now provided to approximately 80 million households, there are only about 12 million African-American households in the country. Although BET currently has a substantial number of non-African American viewers, it can be assumed that the vast majority of subscribers that would select the network on a per-channel basis would be African-Americans and, thus, that subscribership to BET would plummet in an à la carte regime. Indeed, even if all African-American homes opted to subscribe to the service as a per-channel offering—a highly improbable scenario—its license fees would have to increase exponentially just to recover lost subscriber revenue, let alone lost advertising revenue. The service thus would become far less attractive to many of its existing viewers. In such an environment, the network's existence clearly would be put in jeopardy.

Similarly, because new and emerging channels rely so greatly on the access to potential viewers offered through tier-based distribution, an à la carte government mandate would significantly deter the launch of innovative services, particularly by small and independent programmers who are most likely to be short on resources.[67] And more established programmers most likely would focus their efforts on retaining subscribers to their existing networks, rather than taking the undue risk inherent in developing new channels.

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66 *See supra* Section III(A).

67 In its recent study of à la carte issues, the GAO acknowledged this threat to specialized and minority programming, noting that "programming diversity would suffer under an à la carte system because some cable networks, especially small and independent networks, would not be able to gain enough subscribers to support the network." GAO Report at 36. As one network reported to the GAO, "under an à la carte system, fewer networks would remain financially viable and new networks would be less likely to be developed." *Id*.

Further hampering programmers' ability to invest in high quality programming would be the widespread uncertainty resulting from an à la carte regime. Altering the current program distribution model in such a far-reaching manner "would clearly throw the entire industry into a period of disruption and disequilibrium."[68] Moreover, as demonstrated by the example of existing premium channels, per-channel services experience a relatively high level of churn.[69] Consequently, the number of subscribers to any given network could fluctuate dramatically from month to month in an à la carte environment, making it extremely challenging for programmers to project their revenues and, thus, their ability to invest in programming. Under an à la carte system, it also would be very difficult, if not impossible, for Nielsen to make accurate ratings predictions, creating a tremendous amount of uncertainty for advertisers. In such an environment, networks likely would be exceedingly cautious in their program investments, avoiding innovative or particularly costly ventures.[70]

Consumers ultimately would suffer under such a scenario. They most likely would end up with fewer choices, diminished diversity, lower quality, and a higher monthly rate for fewer channels. Indeed, as EI points out in its Report, there is no guarantee that even those consumers who would subscribe to very few channels in an à la carte system—and thus likely would pay lower monthly fees—would be better off overall, as the channels they prefer would not

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[68] EI Report at 8.

[69] *See supra* Section IV(A); Showtime Networks Analysis at 4.

[70] In addition to reducing their investments in programming, networks could be forced to cut back on their community service activities in order to recoup lost revenues. For example, MTV Networks has donated over $48 million in public service airtime since 2003. Among the organizations that have aired public service announcements are Partnership for a Drug Free America, Cable Positive, March of Dimes, National Safety Council, and City of Hope. Airtime has been devoted to such campaigns as *KNOW HIV/AIDS*, MTV's *Choose or Lose 20 Million Loud*, Nickelodeon's *Let's Just Play*, VH1's *Save the Music*, and Spike TV's *Check In or Check Out*. Similarly, BET has donated more than $60 million in public service airtime since 1997 through its *Rap-It-Up* and *A Healthy BET* initiatives, which focus on promoting healthy lifestyles within the African American community, and *Speak Now*, a campaign aimed at increasing voter registration. Such public service activities could be among the first casualties in an environment where programmers are confronted with escalating costs and declining revenue.

necessarily survive the change or maintain current levels of program quality.[71] An à la carte mandate thus could directly threaten the Commission's important and longstanding public interest goals.[72] Given the extensive public interest benefits and proven efficiencies of the current programming distribution system, there simply is no justification for adopting mandates that would undermine that model.

## VI. A SIMILAR PATTERN WOULD EMERGE IF PROGRAMMING WERE REQUIRED TO BE DISTRIBUTED ON THEMED TIERS OR IN A MIXED À LA CARTE/TIERING REGULATORY ENVIRONMENT

The same fundamental chain of economic effects that likely would result from an à la carte government mandate also would be sparked by other regulatory alternatives, such as a themed tiering obligation or a mixed tiering/à la carte system.[73] Mandated themed tiers presumably would result in the packaging of channels into mini-tiers according to content-based categories, such as sports, music, or "family"-oriented topics. Such specified groupings most likely would not be economical for many households. While some individuals may have relatively narrow programming tastes, most watch a broad range of program genres and, thus, likely would need to purchase multiple themed tiers in order to satisfy their interests. This problem would become magnified in multi-resident households. A typical family, for example, may want to want to purchase Nickelodeon for an eight year-old child, The Disney Channel for a 12 year-old, MTV for an 18 year-old, and CNN, ESPN, and Lifetime for the adults—all of which may not be on the same tier. In the real world, of course, the range of interests in many

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71 *See* EI Report at 5.

72 As the agency recently reconfirmed, both programming diversity and innovation remain key Commission policy objectives. *See 2002 Biennial Review Order* at 13632, 13642. In discussing the importance of programming diversity, the Commission further found that this goal is "best achieved by reliance on competition among delivery systems rather than by government regulation." *Id*. at 13632.

73 *See* EI Report at 50-52.

households could be far more varied and diverge from member to member according to their individual tastes. In the end, it likely would be prohibitively expensive for many households to reassemble the range of programming they choose to view under the current system.

Moreover, like an à la carte requirement, a mandated themed tier regime would adversely affect programmer revenues. Because networks in such tiers would be less widely distributed than they currently are, they would suffer a loss in viewership and, thus, in subscription revenues. As a result, advertisers presumably would pay less for spots on such channels, if they would continue to advertise on those channels at all.[74] Further, as EI notes, marketing costs could further escalate because programmers would have to convince consumers to subscribe not only to their networks, but also to some tier of programming that likely would differ across MVPDs.[75]

A hybrid or "mixed bundling" system, in which consumers could choose either à la carte or packaged pricing, could entail even greater costs to programmers. Unsure of whether their networks would be offered by MVPDs across the country to consumers in packages, on a per-channel basis, or both, programmers would be unable to develop uniform marketing strategies. Marketing expenses would rise sharply, as programmers would be forced to adopt strategies to appeal to both individual consumers and MVPDs. Furthermore, programmers would have to develop marketing strategies to appeal to both à la carte and tier consumers, who may have divergent concerns and interests.[76] Just as would be the case under either an à la carte mandate or a themed tiering system, revenue would suffer because networks would lose both actual and

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74 In addition, consumers still could be required to purchase new set-top boxes in order to receive themed or other mini-tiers. *See* EI Report at 50.

75 *Id*. at 50.

76 *See id.* at 51.

potential viewers. Decreased revenues and increased marketing costs, in turn, would mean that less is available to invest in programming.[77]

Under both of these regulatory alternatives, programmers likely would have to raise their license fees to MVPDs in order to continue to fund successful operations. MVPDs would pass those costs on to the consumer, who would be confronted with escalating monthly fees. The same threat to program diversity that would result from an à la carte regime also would be posed here. Accordingly, strict à la carte, themed tiering, and mixed tiering mandates all would seriously jeopardize the consumer benefits made possible by today's system of program packaging and distribution.

## VII. NEITHER MANDATED THEMED TIERING NOR À LA CARTE REQUIREMENTS WOULD SURVIVE FIRST AMENDMENT SCRUTINY

Any government mandate that would require multichannel program services to be offered either in specified "themed" tiers or on an à la carte basis would be riddled with First Amendment problems. Most obviously, regulation mandating the offering of certain themed tiers would be inescapably content-based and, as such, would almost certainly be found constitutionally invalid. Even assuming that a court would view a themed tier obligation as content-neutral, such requirements still would not pass constitutional muster under the applicable intermediate scrutiny test. The same can be said of any requirement that programming be offered on an à la carte basis.

It is firmly established that both MVPDs and programming vendors are entitled to First Amendment protection.[78] The Supreme Court repeatedly has concluded that content-based

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[77] In addition, if regulations required only specified networks to be unbundled, there is no guarantee that the price of the remaining bundled offering would be any lower than the pre-existing price. *See* EI Report at 51-52.

[78] *See, e.g., Turner Broadcasting System, Inc. v. FCC,* 512 U.S. 622, 636 (1994) ("*Turner I*") ("There can be no disagreement on an initial premise: Cable programmers and cable operators engage in and transmit speech, and

regulations imposed on either MVPDs or programmers are subject to so-called “strict scrutiny” and presumptively violate the First Amendment. As the Court has explained, “the First Amendment, subject only to narrow and well-understood exceptions, does not countenance governmental control over the content of messages expressed by private individuals.”[79] Reviewing courts thus “apply the most exacting scrutiny to regulations that suppress, disadvantage, or impose differential burdens upon speech because of its content.”[80] Laws that “regulate speech based on its content or that compel speakers to … distribute speech bearing a particular message are subject to strict scrutiny. Such laws are presumptively invalid and survive constitutional review only if they promote a compelling interest and employ the least restrictive means to further the articulated interest.”[81]

Government action that would require programming to be packaged to consumers based on its program content and themes would be manifestly “content-based.” Such regulations either would impose upon MVPDs and programmers governmentally-predetermined conclusions about what programming does or does not fit under specific, and potentially highly subjective, content-based categories—such as “family friendly”—or would force private entities to make such

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they are entitled to the protection of the speech and press provisions of the First Amendment.”) (*citing Leathers v. Medlock*, 499 U.S 439, 444 (1991)); *United States v. Playboy Entertainment Group, Inc.*, 529 U.S. 803, 811 (2000) (“*Playboy*”); *Satellite Broadcasting and Communications Association v. FCC*, 275 F.3d 337, 353 (4th Cir. 2001) (“[B]oth satellite carriers and cable operators engage in speech protected by the First Amendment when they exercise editorial discretion over the menu of channels they offer to their subscribers.”).

79 *Turner I*, 512 U.S. at 641. In *Turner*, the Court determined that the must-carry obligations imposed on cable operators in connection with the Cable Television Consumer Protection and Competition Act of 1992 were not content-based because they were not at all connected to the specific content aired by any individual broadcaster. *See id*. at 643-52. The same analysis would not apply to content-based tiering obligations.

80 *Id*. at 642.

81 *Time Warner Entertainment Co., L.P. v. FCC*, 93 F.3d 957, 966 (1996) (*citing American Library Ass’n v. Reno*, 33 F.3d 78, 84 (D.C. Cir. 1994) (“*Time Warner I*”) (internal quotations eliminated). In other words, “[i]f a less restrictive alternative would serve the Government’s purpose, the legislature *must use* that alternative.” *Playboy*, 529 U.S. at 813 (emphasis added).

judgments. In either case, the restrictions automatically would be "defined by [the] content" of the speech in question.[82] Any legal requirement that specific programming be either included or excluded from specified content-based tiers necessarily would "impose differential burdens upon speech because of its content."[83] A themed tiering mandate thus would be a classic case of "content-based" regulation and almost certainly would be adjudged as such for purposes of First Amendment analysis. Indeed, just last month, the Supreme Court reconfirmed that such regulations will not pass constitutional muster unless they represent the "least restrictive means among available, effective alternatives."[84]

Even if a reviewing court were to deem themed tiering requirements as content-neutral, such obligations still would contravene the First Amendment under the intermediate scrutiny test. The same would be true for à la carte requirements. Courts repeatedly have held that content-neutral, structural restrictions on cable operators and/or program vendors can impede editorial control and are thus subject to intermediate scrutiny.[85] Such regulations will be sustained only if they "further[] an important or substantial governmental interest; if the governmental interest is unrelated to the suppression of free expression; and if the incidental restriction on alleged First Amendment freedoms is no greater than is essential to the furtherance

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82 *Playboy*, 529 U.S. at 811.

83 *Turner I*, 512 U.S. at 642. Mandated genre-based tiering could subject a network to "differential burdens" *vis-à-vis* its competitors in a variety of ways – *e.g.*, by exclusion from a tier it preferred or by inclusion in a tier it disliked. In each of these cases, the decision to exclude or include would almost certainly be based on content.

84 *Ashcroft v. ACLU*, No. 03-218, slip op. at 8 (S. Ct. June 29, 2004).

85 *See, e.g.*, *Turner Broadcasting System, Inc. v. FCC*, 520 U.S. 180, 213 ("*Turner II*") ("The must-carry provisions have the potential to interfere with protected speech in two ways. First, the provisions restrain cable operators' editorial discretion in creating programming packages by 'reducing the number of channels over which [they] exercise unfettered control.' Second, the rules 'render it more difficult for cable programmers to compete for carriage on the limited channels remaining.") (*citing Turner I*, 512 U.S. at 637); *see also Time Warner Entertainment Co., L.P. v. FCC*, 240 F.3d 1126, 1129 ("*Time Warner II*") (horizontal and vertical ownership limits "interfere[] with [cable operators'] speech rights by restricting the number of viewers to whom they can speak" and "restrict[ing] their ability to exercise their editorial control over a portion of the content they transmit").

of that interest."[86] The harms a restriction is designed to address must be "real, not merely conjectural," and the regulation must "in fact alleviate these harms in a direct and material way."[87]

Neither themed tiering nor à la carte requirements could satisfy this standard. As explained above, mandating the unbundling of program services to subscribers would greatly disrupt the current marketplace and jeopardize many of the efficiencies and public interest benefits promoted by the current system. This disruption would not be counterbalanced by advancing any important government interest, and certainly would not alleviate any public interest harms in "a direct and material way." As demonstrated above, there is no basis for concluding that consumers would benefit, either through lower prices or increased choice, from such regulation. Indeed, both economic evidence and experience strongly suggest that the opposite outcomes are far more probable.

Furthermore, while some parties may assert that regulation is needed in order to shield viewers from programming they may find offensive, mandatory à la carte or tiering offerings simply would not be adequately tailored to this objective to survive constitutional analysis.[88] Indeed, there are mechanisms already in place—in the form of both channel blocking and the V-

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86 *Turner I*, 512 U.S. at 662 (*quoting United States v. O'Brien*, 391 U.S. 367 (1968)); *see also Time Warner II*, 240 F.3d at 1130.

87 *Turner I*, 512 U.S. at 664; *see also Turner II,* 520 U.S. at 189; *Time Warner II*, 240 F.3d 1126.

88 Notably, in striking down content-based legislation requiring cable operators to fully scramble sexually-oriented programming, the Supreme Court has explained that "even where speech is indecent and enters the home, the objective of shielding children does not suffice to support a blanket ban if the protection can be accomplished by a less restrictive alternative." *Playboy*, 529 U.S. at 880; *see also Sable Communications of California, Inc. v. FCC,* 492 U.S. 115, 130-31 (1989) (invalidating a complete statutory ban on "dial-a-porn" messages where feasibility of a technological approach to controlling minors' access would soon be available). Thus, any government interest in shielding consumers from indecent programming certainly could not sustain any regulation found to be content-based.

chip—that enable subscribers to block programming they do not want aired in their homes.[89] Importantly, these devices already achieve the objective of safeguarding viewers from unwanted programming without forcing MVPDs or program vendors to significantly revamp their current system of packaging and distributing programming. Of course, viewers always also have the option of simply not tuning in to programming they find undesirable.[90] Thus, as a means to protect viewers from programming they find undesirable, mandatory themed tiering and à la carte offerings undeniably would burden "substantially more speech than necessary" and could not be characterized as "narrowly tailored" restrictions. In the final analysis, the interests, if any, served by a content-based tiering or à la carte mandate simply would not suffice to violate the First Amendment rights at stake.

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89 In its recent decision regarding the Child Online Protection Act (COPA), the Supreme Court, in upholding a lower court finding that there were less restrictive means available than the law, specifically found that "blocking and filtering software is an alternative that is less restrictive than COPA." *See Ashcroft*, slip. op. at 8.

90 *See, e.g.*, *Playboy*, 529 U.S. at 814 ("Where the designed benefit of a content-based speech restriction is to shield the sensibilities of listeners, the general rule is that the right of expression prevails, even where no less restrictive alternative exists. We are expected to protect our own sensibilities 'simply by averting our eyes.'") (*citing Cohen v. California*, 403 U.S. 15, 21, 29 (1970)).

## VIII. CONCLUSION

In sum, there is no legitimate basis for jeopardizing today's well-functioning program distribution system through the imposition of à la carte and/or themed tiering regulations. The current system provides consumers with high-quality and remarkably diverse programming in a highly efficient, reasonably priced manner. The imposition of à la carte or tiering mandates, on the other hand, needlessly would both raise consumer costs and result in a pronounced decrease in program quality and diversity.

Respectfully submitted,

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July 15, 2004

# ATTACHMENT 1

# Cable Networks: Bundling, Unbundling, and the Costs of Intervention

**by**

**Bruce M. Owen and John M. Gale**

**July 15, 2004**

***Economists Incorporated***

**Washington DC**

**Cable Networks: Bundling, Unbundling, and the Costs of Intervention**

**by**

**Bruce M. Owen and John M. Gale**[†]

## Summary

Congress has asked the Commission to respond to a series of questions regarding the manner in which programming is sold to cable operators and direct broadcast satellite systems (collectively, "MVPDs") and to subscribers. The questions focus on the economic and legal impact of possible changes in the way programming is sold, to be mandated by law or regulation. These possibilities include requiring suppliers[1] to license their cable networks to MVPDs individually (à la carte*)*, rather than as bundles;[2] requiring suppliers to permit MVPDs to resell cable networks either à la carte or as part of a theme tier; mandating à la carte pricing; mandating theme tiers; and mandating a "family tier." In order to help prepare its response to Congress, the Commission issued a Public Notice seeking

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1 Throughout the paper, network refers to a specific "cable" network, such as Nickelodeon or CNN, marketed to MVPDs, whereas supplier refers to the entity that owns a network or group of networks, such as Viacom or Time Warner.

2 We use the terms "unbundled" and "à la carte" synonymously herein.

comment on factual questions regarding the provision of à la carte and theme tier services by MVPDs.[3]

Viacom asked us to provide economic analysis of certain issues raised by the various proposals. Specifically, we address the following issues:

- Do upstream suppliers of scheduled program services ("cable networks") licensing to MVPDs require MVPDs to purchase bundles of cable networks rather than offering program services individually?
- Is the MVPD practice of offering bundles or tiers of services to retail subscribers harmful to consumers? What would be the effect on cable networks and consumers of a regulation requiring MVPDs to offer programming à la carte, with or without continued bundling?

We address these issues factually where time and available data permit, and in any case conceptually. Our conclusions, briefly, are as follows:

1. Bundling is an extremely common phenomenon in the American economy. Indeed, it is more the rule than the exception. Bundling presents no presumptive threat to consumer welfare. In fact, bundling generally promotes consumer welfare by lowering the prices of goods and services. Whether and how to bundle components is an important aspect of the competitive strategies of individual firms. In general, an external regulatory constraint making bundling unlawful will reduce welfare by increasing costs. This is true whether or not sellers have market power. While a

[3] FCC, "Comment Requested on À La Carte and Themed Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems," MB Docket No. 04-207, May 25, 2004 (hereinafter "Public Notice").

regulatory intervention restricting bundling is likely to reduce overall welfare, it may increase the welfare of those consumers who prefer highly customized services, but at the expense of consumers who prefer highly bundled services. There is no basis to predict that any consumers who may be better off have a special claim on society, such as poverty or geographic isolation. Thus, giving each consumer equal weight, consumers as a group will be worse off if bundling is not permitted.

2. Our empirical research contradicts the idea that suppliers generally require MVPDs to purchase bundles of programming. The cable network industry is competitive. MVPDs have many sources of programming and can vary the proportions in which they buy programming.[4] Entry into the business of providing programming to MVPDs is not restricted, as evidenced by the actual entry of more than 200 new networks in the past decade.[5] Suppliers of cable networks may well offer bundles of networks to MVPDs, but they must offer a price for the bundle that is no greater than the sum of the competitive prices of the individual networks, compensating their customers for taking low-value networks by, in effect, lowering the price of their most popular networks. In any event, the evidence is that cable networks are not systematically purchased by MVPDs as bundles. For example, a large percentage of 2,455 cable systems studied do *not* carry all the networks offered by leading suppliers such as Time Warner, Discovery, Dis-

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4 One piece of evidence attesting to the increasing competitiveness and efficiency of wholesale suppliers of programming has been the decline in the extent of vertical integration in the industry. See FCC, Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, Tenth Annual Report, MB Docket No. 03-172, 2004, Table 8.

5 Id.

ney and Viacom. These data also show that suppliers license their networks in many different combinations and on a stand-alone basis.

3. Our economic analysis of the competitive forces on cable networks leads us to predict that suppliers would offer MVPDs a substantially lower price in exchange for placing any network on a tier that matches that network's national marketing strategy. Cable networks generally must adopt a particular marketing strategy in order to survive competitively. One important choice is whether to offer "premium" programming supported solely by subscription license fees or "basic" programming, supported by advertising and license fees. There are advantages if the strategy is uniform across markets for any given network, chiefly because the different strategies call for different program qualities, but also because customized marketing is more expensive than national marketing. Therefore, cable networks will prefer a particular tier placement, and will likely offer a better price to MVPDs who agree to that placement.

4. Prices cannot be ignored. Neither the issue of whether MVPDs are required to buy bundles of programs nor the issue of whether they are required to place certain cable networks on certain tiers can be addressed in the absence of price comparisons. To understand this, consider whether a shopper who is offered a quantity discount for laundry soap, for example, is *required* to buy a larger quantity. Assuming for the sake of argument, and contrary to common sense, that the answer is yes, requiring the soap powder to be "unbundled" is no solution unless the government is prepared to regulate both the sizes of the components and their prices.

5. The last point is especially important. It is very difficult to imagine an effective law or regulation requiring unbundling of MVPD networks, either

at wholesale or retail, that was not accompanied by government regulation of the prices and license fees and other terms of trade between cable networks and MVPDs and between MVPDs and retail subscribers. Such regulation would be far more complex than the Commission's attempts to regulate the prices of unbundled elements of local telephone service.

6. We examine the limited empirical evidence bearing on the effect of mandated unbundling on specific cable network à la carte retail prices. Making a series of assumptions, and not attempting to account for certain important but unknowable factors, we offer a rough empirical basis for predicting the effects of mandated unbundling of particular cable networks at the retail level. We find that at the mid-point of the ranges considered the average cost per subscriber (exclusive of the basic tier fee and converter box fee) for ten à la carte networks would be $44.60. These calculations, summarized in Table 4, strongly suggest that consumers will end up paying substantially more than they do now for the present collection of cable networks or for any substantial subset of networks. Consumers who wish to subscribe only to a very few of the existing networks, including consumers who currently do not subscribe to any expanded tier, may be better off. However, these are short-term "partial equilibrium" predictions. In the longer term, there is no assurance that the networks such consumers prefer will survive the change, or, if they do, that they will retain their current levels of program quality.

7. Unbundling clearly will increase the costs to viewers of sampling content on cable networks they do not regularly watch. This provides a firm basis to predict that the effect of the proposed interventions would be to impair

the ease of access of all Americans to new ideas and contrary and minority viewpoints.

8. We consider, last, the proposal to mandate certain bundles of content organized according to specified themes. An example is the proposal for a "family tier." Based on the analysis in Section V, we conclude that consumers who subscribed only to such a bundle would pay as much or more than they do now, and that some or all of the networks that they currently receive might no longer exist. Moreover, unbundling only a few specific networks might not reduce the price of the remaining bundle of networks. Further, for reasons explained in Section VI, we think that overall consumer welfare would be adversely affected by mandated unbundling or tiering, and that it would raise substantial First Amendment issues.

## I. Introduction

The task before the Commission in responding to the Congressional inquiry is extraordinarily difficult and complex. To illustrate the difficulty, consider the proposal to require MVPDs to offer all cable networks à la carte, either as the only alternative or in combination with various tiers.

Many cable networks are dependent upon a dual revenue stream, consisting of advertising revenues and subscriber fees. It is reasonable to expect that, if a cable network were taken out of the basic or expanded basic bundle and instead offered à la carte, it would lose subscribers. A reduction in subscribership, holding subscriber license fees and advertising rates constant, would reduce revenues in both these categories.

In addition to these revenue losses, if a cable network were taken off a tier and offered à la carte it would incur additional transactional marketing and associated costs. Transactional marketing consists of tactics, activities and resources designed to generate subscriptions to an à la carte network by stimulating consumer demand and influencing consumer choice. A cable network offered to consumers à la carte would face these additional marketing costs in order to overcome the higher search and transactions costs faced by potential viewers. The network would have to compete with dozens, if not hundreds, of other networks for the consumer's dollar.

There are many factors to consider in assessing an à la carte regime. How will suppliers of cable networks respond? How will MVPDs respond? How will consumers respond? How will providers of inputs, such as rights holders, respond? How will competitive interactions among networks change? All of these factors and their interactions affect what will happen to subscriber rates for cable programming under an à la carte regime. One cannot confidently predict all the specific long-run changes that would result from restricting the way cable programming is sold. Bundling of cable networks is part of a complex system of related economic decisions that involve program quality and marketing as well as pricing.

Section V below describes our empirically-based effort to predict the effects of unbundling on the weighted average network price. Such predictions necessarily cannot account for certain important but immeasurable factors, such as consumer demand for individual networks and future competitive interactions among cable networks and MVPDs. Predicting what will eventually happen, to what extent, and to which cable networks, is immensely complicated by the fact that a rule requiring a change in marketing practices would affect all MVPDs, nearly all program suppliers and nearly all networks. While one might hope to model the behavior of any one cable network holding the behavior of other networks constant, changes of the magnitude proposed would clearly throw the entire industry into a period of disruption and disequilibrium. It is beyond this paper's scope to model and describe with certainty the duration of this period of disruption, the likely new industry equilibrium, if any exists, much less the path the industry would follow, during a period of uncertain duration, to arrive at such an equilibrium. Nevertheless, the lost advertising revenues and higher costs associated with à la carte pricing are likely to persist in the long run, and to result in a permanent reduction in aggregate welfare.[6]

6 We think it likely that the proposed interventions would reduce the size of the economic pie available to be shared by all consumers. However, despite the smaller overall pie, some consumers may be better off as measured by their surplus from consumption of MVPD services. When we predict reductions in overall welfare we are implicitly giving equal weight to each consumer. This assumption is justified by the absence of any apparent correlation between

Although predictions regarding specific networks are difficult, some generalizations are possible. Clearly, any loss of subscriber or advertising revenue and any increase in costs would in the first instance increase consumers' per-network subscription prices, reduce program quality, cause the exit of some networks, and limit the entry of new networks. Hence, the change in pricing would reduce the variety and breadth of programming offered to subscribers. Moreover, it would reduce what a cable network is willing to pay for both original and syndicated off-network programming, reducing the quality of cable programming offered to subscribers as well as the quality of certain types of broadcast network programming.[7] Also reduced would be the revenues earned by certain program inputs with possible further reductions in the quantity and quality of their output. All of these effects will serve to reduce consumer welfare. Subsequently, competitive interactions would take place among cable networks and among MVPDs, further complicating one's ability to predict specific effects.

The uncertainty of impacts on specific consumers and suppliers within this overall picture is itself a strong argument against requiring programmers and MVPD systems to make such a drastic change. Regulatory interventions, once instituted, are difficult to reverse.

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those likely to benefit from unbundling and the characteristics traditionally associated with unequal weighting of income. In this respect mandatory unbundling resembles an economically inefficient tax that transfers income from one randomly selected group of consumers to another, reducing GNP in the process.

7 Part of the cost of certain types of broadcast network programming is recouped from sale of the programming into syndication. If syndication revenues, such as payments from cable networks, are decreased, creators of broadcast programming will have to reduce production costs, and quality, of new broadcast network programming.

Another consequence of required à la carte pricing is predictable in direction if not in magnitude. That consequence would be a reduction in the opportunity of American households to be exposed to different points of view and new ideas. To see how this would come about, consider the difference between the way in which MVPDs currently provide networks (i.e., bundled) and the way that magazine publishers offer subscriptions (i.e., à la carte). Many consumers today can sample or "surf" across the various video options available to them, deciding to settle on a particular network based on the attractiveness of a quick sample of the programming. This facilitates the opportunity for content suppliers to compete for viewer attention across disparate sources and genres.

In contrast, the subscription model used by the magazine industry (or, for that matter, by premium movie and sports networks) does not permit such easy "surfing." A given consumer typically makes a decision at some point to subscribe to *Time*, *Newsweek*, *The Economist*, or another newsweekly, and thereafter relatively seldom has the opportunity to sample the content of the magazines not subscribed to. Other things being equal, this reduces the opportunity for consumers to be exposed to new ideas and new ways of expressing them, or different opinions.

The magazine industry and the cable network industry arrived at their current competitive marketing strategies by different historical paths that may well be sufficient to explain the present differences between their marketing strategies. If magazine distributors were to bundle magazine subscriptions (and offer "family" collections of magazines) they could reduce costs and probably would make some magazine readers better off economically and others worse off economically. The opposite requirement, applied to the cable industry as proposed, similarly would benefit some viewers and harm others. In both cases there is likely to be a negative net welfare effect on consumers as a group.[8] But it seems clear that the cause of greater diversity of viewpoints and a better informed public would be better served by forcing publishers to offer bundles and tiers—much the same way the government requires cable operators to sell a basic service tier of broadcast signals—rather than by forcing MVPDs to do the opposite.

Section II of this paper contains a general discussion of bundling and pricing. Section III describes our empirical analysis of the carriage of cable networks by over 2,400 cable systems representing about 80 percent of cable subscribers. Section IV discusses how subscriptions, cable advertising revenue, and cable network costs are likely to be affected by unbundling. Section V describes the data we examined, and the analysis we conducted in an attempt to predict (in a partial equilibrium framework) the effects of mandated à la carte pricing on the prices of cable networks. Section VI offers a brief analysis of the proposal that MVPD systems provide program tiers based on content, an issue to which the analysis in Section V is also applicable.

8 Magazine industry costs would increase because such bundling would require an intermediate layer of distribution, which we assume would exist if consumer benefits justified its costs. (See also note 6.) There is a theoretical possibility that path dependence and changing conditions have led one or the other of these two industries to equilibrium pricing strategies that are no longer globally efficient. The Commission faces insuperable practical difficulties in exploring this possibility, and even if these were overcome, still greater difficulties in fashioning a remedy that would be responsive to changing conditions of technology and demand.

## II. Background

### *A. Bundling is a universal and benign practice*

Almost every product and service purchased by consumers is "bundled," by sellers, from various components that could each, at least in principle, be sold or priced separately. Purchased bundles are then further combined, by customers, into useful consumption activities. A consumer who wishes to make and drink tea buys several bundles: teabags (consisting of tea, filter paper folded into pouches, string, staples, packaging, advertising, transportation, wholesale and retail services); milk (consisting of raw milk, processing, packaging, advertising, transportation and retail services); sugar (you get the idea); energy to heat the water, and other inputs (e.g., crockery) into the activity of making tea. Most of the components of each bundle could be purchased separately. The consumer herself bundles the bundles into a hot cup of tea.

In the tea example, it is important to note that the price a consumer is likely to pay for bundles such as a teabag or a quart of milk is much lower than what the consumer would pay to purchase all the various components, even aside from the cost to the consumer of assembling the components. This relationship between the price of components and the price of bundles is common, and reflects supply-side economies. One way to think about this price relationship is that customers who want highly personalized, tailor-made products have to pay a premium because they incur costs that are not spread over a large number of fellow-consumers.

Bundling occurs for a variety of reasons. Probably chief among them is that sellers can assemble parts into bundled units more cheaply and efficiently than customers. Customers get a bundled product for a lower price, which they prefer to a self-assembled product, even though the self-assembled or tailor-made product might more closely match their own special tastes. Sellers obtain competitive advantage from offering bundles of components that are cheaper and/or better suited to the demands of various consumers, and the competitive market process tends to ensure that the driving force behind the assembly of bundles is consumer satisfaction.

A seller decides what components to bundle, and which components to offer for sale individually or in other bundles, in light of its costs and its understanding of what will appeal to customers and the current and expected future marketing strategies of competing sellers. Economists have constructed numerous abstract models of this decision-making process. These models demonstrate, in general, that a given seller's profit-maximizing marketing strategy depends on many factors, including the details of production and demand conditions. Generalizations are very difficult to come by, partly because different bundling strategies produce different impacts on one group of consumers than on another. This makes policy analysis extremely complicated. For example, while it is possible to think of assumptions about demand or cost conditions under which (imperfect) competition does not always maximize consumer welfare, these conditions do not suggest any feasible remedial policy intervention.[9]

Thus, while market power where it exists may reduce consumer welfare, bundling may make things either better or worse. As with competition, even when bundling leaves consumers worse off, it is usually difficult to specify a feasible

[9] Similarly, bundling by a firm with any degree of market power may either increase or decrease consumer welfare (relative to simple component pricing, holding other things equal). Our point is that market power is neither necessary nor sufficient for bundling to have adverse effects on consumer welfare.

policy intervention. For example, requiring that an imperfectly competitive firm offer both a bundle and its components (mixed bundling) or no bundles, is likely to be meaningless unless prices are regulated. But no regulator in the real world is likely to be able to obtain the demand and supply information required to ensure that such firms price efficiently.

*B. Pricing is an essential part of the analysis of bundling, and price regulation would be an essential element of mandated unbundling*

It is important to understand that most of the Commission's questions cannot be answered meaningfully without consideration of the *prices* at which various components and bundles are offered, a daunting task. For example, what does it mean when a customer chooses a particular bundle that costs less than the sum of the individual prices of a subset of the components of the bundle? Is such a customer "required" to buy the bundle, or is the customer simply offered an opportunity to take advantage of the cost savings that result from bundling, giving up some tailoring in return? Clearly, the latter interpretation is the correct one.

More ominously, consideration of such pricing issues leads fairly directly to the conclusion that mandatory unbundling is likely to be ineffectual if it is not accompanied by regulation of prices. The Commission has ample and unhappy recent experience with unbundling requirements and associated pricing issues in the telephone industry. Those telephony-related issues are, from a technical economic point of view, almost trivial in comparison with what the Commission would face in determining regulated prices for intellectual property whose consumption is non-rivalrous. By this we mean that efficient telephone component pricing focused on long-run forward-looking incremental cost, with controversy centering on which stakeholder would bear the burden of unrecovered historical costs. In video programming, the Commission would be faced with an economically efficient price (from a demand-side perspective) of zero, but with a potentially large positive price required to induce production of the next day's programs. The incentive effects of stranded costs would not be a side show, they would be the whole show.

## III. Evidence on how cable networks are sold to MVPDs

### *A. Existing cable network sales practices*

Here we investigate whether suppliers require MVPDs to purchase bundles of cable networks. We address that question by examining the programming carried by a large sample of cable systems. The data indicate that a substantial percentage of cable systems do not carry all the program services offered by leading program suppliers such as Time Warner, Discovery, Disney and Viacom. This evidence contradicts the allegation that upstream suppliers of programming to MVPDs require MVPDs to carry all of the supplier's offerings.

Available data on the networks carried by cable systems across the country confirm that systems can and usually do choose to carry some but not all of the networks from any given program supplier. We obtained data on cable network carriage by cable system from Warren Communications.[10] For our analysis, we excluded cable systems that reported carrying fewer than 35 satellite-delivered basic cable networks. It is likely that some of these systems did not report all of the networks they carry, and including such systems could overstate the extent to which certain networks were not carried. Other excluded systems may have relatively small channel capacity and, therefore, are clearly not required to carry all networks that the programming suppliers offer simply because there would not be enough channel capacity to do so.

Our analysis therefore focused on 2,455 cable systems, representing approximately 80 percent of cable subscribers, that reported carrying at least 35 sat-

[10] Warren Communications News, *Televisions and Cable Factbook: Online*, June 2004.

ellite-delivered programming services on their basic and expanded basic tiers of service. (These systems typically carry broadcast channels, local origination programming, premium cable networks and pay-per-view services in addition to the basic cable networks.) Nine program suppliers that own multiple basic networks were identified, and carriage of those networks by the cable systems was examined. For each supplier of commonly-owned basic cable networks, a count was made of the number of systems carrying one network of that supplier, two networks, etc. The networks offered by each supplier are listed in Appendix A. Networks launched later than 2000 were not included with the relevant supplier. A network launched just last month, for instance, would be too recent to be reflected in the data, if carried at all. In addition, in a test of the proposition that network suppliers require MVPDs systems to carry all the supplier's programming, a recently launched network might not be carried because an MVPD's current carriage agreement may have been signed before the network was launched.

Table 1 shows, for various network suppliers, what portion of cable systems that take any of the supplier's networks take all of its networks. This can be seen in the far right-hand column. For instance, of the 2,454 systems that carried any A&E network, 1,185 or 48 percent carried all four A&E networks. In other words, more than half of the systems carrying any A&E network declined to take all the A&E networks. For most of the other network suppliers shown in Table 1, far less than 50 percent of the systems taking any network carried all the networks. This means that for most suppliers shown, the overwhelming majority of systems declined to take all the networks.

**Table 1: Percentage of systems carrying at least quarter, half or more, three-quarters or all the basic cable networks, by supplier group**

| Supplier | Percentage of cable systems carrying indicated proportion of supplier's networks: One quarter or more | Half or more | Three quarters or more | All |
|---|---|---|---|---|
| A&E | 100% | 98% | 53% | 48% |
| Cablevision | 100% | 74% | 55% | 25% |
| Comcast | 100% | 83% | 69% | 41% |
| Discovery | 97% | 74% | 71% | 5% |
| Disney | 100% | 96% | 62% | 23% |
| Fox | 100% | 90% | 74% | 39% |
| Lifetime | n.a.‡ | 100% | n.a.‡ | 50% |
| Time Warner | 100% | 100% | 74% | 4% |
| Viacom | 98% | 67% | 13% | 0% |

‡ Lifetime has only two networks included in this analysis, so the one quarter and three quarter columns are not applicable.

The data underlying Table 1 also show that network suppliers sell their networks in many different combinations and on a stand-alone basis. To take Cablevision, which owns four networks, as an example, 26 percent of sample systems carried only a single Cablevision network, 19 percent carried only two Cablevision networks, 30 percent carried only three, and 25 percent carried all four Cablevision networks. This pattern probably understates the diversity of offered "bundles," because systems that carried the same number of Cablevision networks would not necessarily have taken the same networks.

Several of the questions in the Public Notice appear to link "bundling" by programmers selling their networks to MVPDs with "bundling" by MVPDs providing networks to consumers. Linking these two issues may reflect a misunderstanding. Whether or not MVPDs are required to purchase certain bundles of networks from network suppliers has no necessary connection to whether MVPDs will offer the networks to their subscribers bundled or à la carte. MVPDs have flexibility in the way they purchase their programming from suppliers, as shown in Table 1, and MVPDs offer basic programming in tiers or bundles. Even if, hypothetically, an MVPD were required to carry all of a supplier's networks if it chose to carry any network in the group, this would not change the MVPD's decision about whether to offer those networks to subscribers bundled or à la carte. Alternatively, if a network supplier were prohibited from selling any of its networks as part of a bundle, the MVPD could still bundle the networks it carries. In short, there is no particular connection between wholesale and retail bundling in this context. Of course, any higher prices and reduced program quality effects introduced by regulations aimed at preventing bundling at the wholesale level will be passed through to retail consumers.

### *B. Should cable networks be prohibited from bargaining for tier placement?*

We also set out to investigate whether program suppliers now require MVPDs to place particular networks on particular tiers. For the reasons set out below, we do not believe that it is possible to answer this question empirically, at least in the time available. We conclude that it would be rational for competitive suppliers of cable networks to offer substantially lower license fees to MVPDs who agree to carry particular networks on particular tiers.

Cable networks compete with each other not only in the compilation and sale of programming but also in the sale of advertising. Each network's competitive strategy includes the type and quality of programming it offers, the size and demographic composition of the audience it aims to produce for sale to advertisers, a marketing strategy, and the prices it will offer to MVPDs for its programming and to advertisers for its audiences. Given the large number of competing program services and the ease of entry, marketing a cable network is a complex and risky endeavor.

A supplier chooses its own competitive strategy based on an assumption about whether the network will be bundled with other networks or will be sold à la carte by MVPDs. A given supplier would adopt one national promotional and marketing strategy, and associated pricing and programming decisions, if the network were offered as part of a tier by MVPDs, but probably an entirely different competitive strategy if the network were sold à la carte by MVPDs. Both promotion of the network and programming purchased or produced for the network are necessarily national decisions; they cannot easily be varied geographically. The same is true of national advertising sales. A supplier therefore will be at a disadvantage in competition if its programming service is not marketed uniformly by all MVPDs.

It is therefore understandable that suppliers would seek to ensure that their cable networks are carried on commensurate tiers on all MVPDs. Other things being equal, this policy gives each network an equal foundation to succeed in competition with its rivals.

Nevertheless, the benefits of uniform national placement of a given network are not infinitely large. At least in principle, there is some price that an MVPD could offer to pay that would compensate a supplier for the losses it would sustain as a result of non-standard tier placement by that MVPD. Thus, a supplier might offer its cable network at a given price to an MVPD, but also offer a substantial discount for the MVPD's acceptance of a contractual obligation to carry the network on a given tier or to carry additional networks. MVPDs might interpret or characterize such offers as requiring them to offer a given network as part of a given tier.

There is no guarantee that the maximum price an MVPD would be willing to pay for a given cable network to be retailed à la carte would be greater than the minimum price that would compensate the network supplier for the costs that a less uniform marketing strategy would impose. In the real world, firms with limited time and resources do not offer hypothetical bargains that they know in advance will likely be unacceptable. Thus, we would not necessarily expect to find evidence of actual offers or negotiations of this kind. In any event, such evidence is not publicly available, and might have to be obtained through interviews and other such techniques. Even if such evidence were obtained, it would shed little useful light on any public policy issue, because the pricing pattern indicated could easily arise under competitive behavior on the part of program suppliers. Thus, efforts by suppliers to ensure that their networks are marketed in a uniform way at retail cannot be interpreted as anticompetitive or harmful to consumer welfare.

## IV. Effects of unbundling on the economics of a basic cable network

We turn next to whether the MVPD practice of offering bundles or tiers of services to retail subscribers is harmful to consumers. And more specifically, what would be the effect on cable networks and consumers of a regulation requiring MVPDs to offer all programming à la carte, either by network or by program, with or without continued bundling?

The first part of this question was addressed at a conceptual level in Section II above. Bundling is a universal feature of the economy, and greatly improves consumer welfare by enabling consumers to share the fixed costs of creating goods and services from component parts.[11] Based on current knowledge, there is no more reason to assume that bundling of cable networks into tiers is harmful to consumers than it would be to assume that bundling individual programs into schedules (i.e., networks) is harmful, or that bundling tires with new cars is harmful.

The second part of the question requires simulation of the operation of the industry under conditions different from today's circumstances. That is, an assessment of the impact of bundling and pricing practices requires a specific counter-factual or "but-for" world. An initial issue is what regulatory change is being contemplated. The Public Notice does not make clear exactly how MVPDs might be required to unbundle the networks they offer to subscribers. The following are some possibilities.

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[11] Nevertheless, it is possible to construct hypothetical circumstances in which bundling is harmful. These circumstances are technical, not easily characterized, and differ from one market to another.

1. Pure à la carte—all cable networks must be sold individually and MVPDs may not bundle networks within or beyond the basic "broadcast only" tier. (We assume that, due to government-mandated must carry rules, broadcast networks and PEG channels would continue to be bundled on a basic service tier. We also assume for simplicity that any à la carte requirement would not extend beyond networks, that is, would not require each program to be priced individually, even though there is no obvious logical reason to stop at the network level.)

2. À la carte with bundling permitted—MVPDs are required to offer all cable networks à la carte and also permitted to offer certain bundled packages of some or all of the networks.

3. Limited à la carte—MVPDs are required to sell only certain networks, or certain types of programming (e.g., ESPN or sports more generally), à la carte.

4. Theme tiers—MVPDs are not required to price à la carte, but must create theme tiers that could be individually purchased.

We believe that all of these options will have similar effects since they all involve an element of unbundling. Therefore, we begin by examining pure à la carte. Under pure unbundling, the MVPD charges a flat fee for the basic service tier—consisting of broadcast television and PEG programming—and offers all other programming à la carte. In Section VI we discuss how the existence of theme tiers or a mixture of à la carte and tiers would alter our conclusions. The analysis focuses on how programming suppliers might be affected by unbundling and what impact this might have on consumers. The impact on MVPDs, or the exact response of MVPDs to changes in wholesale program pricing, is not studied in detail.

This section explores the effects of mandatory unbundling on the economics of a basic cable network in a partial equilibrium framework. The effects unfold as a multistage process, with the impact from one stage influencing the next stage. The process starts with consumers' decisions whether to subscribe to the network. An overview of the sequence of the stages and the impact at each stage is as follows:

• Stage 1: Subscribers—If a cable network were taken off a tier and offered à la carte it would likely lose subscribers. The consumers that choose to subscribe will likely have been heavy viewers of the network.

• Stage 2: Reach—Given a reduction in subscribers, a cable network's audience will decline. In addition, the network's reach will decline because non-subscribers cannot readily sample the network. The network will be placed at a greater disadvantage in attracting advertising relative to the broadcast networks, which are distributed to virtually all television households.

• Stage 3: Viewers—Networks sell audiences to advertisers. A reduction in subscribers will reduce viewing. For each network, typically there are heavy viewers, medium viewers, light viewers and non-viewers. The percentage of each type varies by network. Since heavy viewers are more likely to choose to subscribe, the reduction in viewers will be less than the reduction in subscribers. Nonetheless, the loss of light and possibly medium viewers will significantly reduce a network's overall viewership, and reduce the ease with which the network can expand viewing by making changes in programming and promotion.

• Stage 4: Advertising Revenue—Advertising revenue depends on distribution (the number of subscribers regardless of how much they watch), viewers, and CPM. To an approximation, a cable network's advertising revenue will decline by about the same percentage as its viewership. However, the decline in the network's distribution and other factors will also affect the network's ability to generate advertising revenue.

Unbundling will also affect a cable network's economics in other ways. This section discusses the following two:

• Hit Programs—A network's ability to create and grow a hit program will be reduced since consumers that do not subscribe to the network cannot easily sample the network's programming. This will limit a network's ability to increase subscribership and advertising revenue.

• Marketing Costs—A network will incur additional costs associated with generating consumer demand for the network. These additional transactional marketing costs would likely be hundreds of million of dollars a year.

All of these effects will put pressure on a network to generate additional revenues from subscribers. The effect of unbundling on subscriber prices is explored in Section V.

*A. Consumer demand for basic networks*

When consumers purchase a bundled tier of networks from an MVPD, they pay a single price for the bundle but no explicit price for the individual networks contained in the bundle. Moving to an à la carte regime would obviously drastically change this arrangement. In some sense, consumers that receive a bundle of networks for a single payment may view each of the individual networks as having a zero price, because there is no incremental cost to viewing any of the networks within the bundle. With unbundling, consumers will be asked to move from an effective zero price for a network to some positive price for that network. In addition to the explicit price for subscribing to an additional network, there would be an implicit associated transaction cost. This pricing change is so dramatic that current consumer behavior regarding basic networks provides virtually no information about behavior in an à la carte world. Specifically, it is difficult to estimate what portion of consumers would choose to subscribe to a given network at various alternative à la carte prices set by their MVPDs. The effect is likely to differ across networks, may vary depending on whether the network provides niche programming or general interest programming, and may depend on the number of other networks that offer a similar type of programming.

It is probably reasonable to assume that if a cable network were taken off a tier and offered à la carte, other things being equal, it would lose subscribers. At any positive price set by the MVPD, the consumers most likely to decline to take the network à la carte would probably be those who viewed the network least intensively when it was offered as part of a tier. Among the consumers who would be lost from the subscriber base are those that rarely or never watch the network and would pay only a modest amount to preserve their option to watch the network occasionally or for special events.[12] If the price for the network were somewhat higher, some consumers that previously viewed the network to a greater but still small extent would also choose not to subscribe à la carte. The consumers

[12] There may be some networks, such as the Weather Channel and the various cable news networks, that are valued chiefly as an option. The impact of à la carte pricing on such channels depends on the ease with which consumers expect to be able to subscribe to it when a relevant contingency arises, such as a serious storm.

that choose to subscribe à la carte will include those that place a relatively high value on the network. Because incremental subscribers do not increase program production costs, the cable network will attempt to maximize revenue.[13] The price that accomplishes this depends on the elasticity of demand at various points on the demand curve for each cable network.

Appendix B summarizes some recent economic studies that have examined consumers' willingness to pay for basic cable networks. It also reviews the current pricing and subscription rates for three premium services. We find that the available evidence is not sufficient to predict the demand curve for individual networks under à la carte pricing.

In addition to the obvious changes in marketing and pricing strategies that would be imposed on program suppliers by à la carte pricing, there would be a significant reduction in consumer awareness of competitive options, as described above. To illustrate, imagine what would happen if newspapers were required to offer each section of their publication à la carte. Subscribers who now glance at, but do not read, certain sections would lose their current awareness of the content of such sections. When and if such content becomes relevant, they would have to engage in a relatively costly search process.

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13 There are, however, positive transactional and perhaps incremental marketing costs. See herein at Section IV.C. Further, while program costs are fixed in the short run and do not vary with audience size, program costs are endogenous in the long run. Other things being equal, in equilibrium attracting larger audiences will require higher program expenditures.

*B. Cable advertising rates and revenues*

**1. Overview**

On the one hand, there appears to be a belief held by some individuals that if the number of subscribers to a cable network were reduced by some percentage due to unbundling then the network's advertising revenue would be reduced by the same percentage. On the other hand, some other individuals appear to believe that if a cable network is sold à la carte it will lose only those current subscribers who do not watch the network, or only rarely watch the network, and therefore there will be only a negligible impact on the network's advertising revenue. This section explores the relationship between subscribers, viewers, and advertising revenue.

The hypothesized proportional relationship between tier subscribers and network revenue might roughly hold when a reduction in subscribers is due to MVPD systems no longer carrying a given network. But the proportional relationship is unlikely to hold if the reduction in subscribers is due to consumers' self-selecting to subscribe under an à la carte regime. Advertisers obviously care about the number of viewers and their demographic characteristics. Self-selected subscribers are more likely to view the network than the average tier subscriber. However, unbundling will still produce some reduction in a network's advertising revenue, because there will be a reduction in viewership due to the fact that not all viewers of the network when it was part of the bundle will subscribe to the network if it is sold à la carte. Having fewer viewers reduces advertising revenue because it lowers both the number of viewers and the advertising rate paid per viewer.

Reducing an audience will not normally increase the total value of the audience to advertisers unless the audience thereby becomes demographically more homogeneous in a way that is useful to advertisers. For example, some non-golfers may watch The Golf Channel, but moving The Golf Channel to à la carte might eliminate all but the avid golfers from the audience, potentially making advertisers of golf clubs willing to pay more per viewer—but advertisers of automobiles, beer, etc. inclined to pay less. Whether this exception is important is an empirical issue. However, most advertising revenue, even for such specialized magazines as *Golf World*, is **not** from specialized advertisers, but rather from the major marketers, and the same is true of specialized cable networks.

### 2. Cable network reliance on advertising revenue

The impact of any reduction in advertising revenues caused by unbundling will likely vary widely across cable networks. Some basic cable networks depend on advertising for most of their revenues, while others are much less dependent on advertising. Kagan Research has estimated 2003 net advertising revenue and total net revenue for 107 basic cable networks.[14] See Table 2. At the extremes, over a dozen of these networks rely on advertising for less than 10 percent of revenue, and there are a couple of networks that are estimated to have no revenue other than advertising. The median value of advertising revenue as a portion of total

[14] Disney, Fox Movie Channel, and Turner Classic Movies were included as having zero reliance on advertising although this was not explicitly reported by Kagan. Chronicle DTV was excluded as it was reported by Kagan to have zero Net Advertising Revenue and zero Total Net Revenue. Blackbelt TV was excluded as it was reported by Kagan to have no subscribers. Nick Too was excluded because it is a time-shifted feed of Nickelodeon/Nick at Nite. Sundance Channel was excluded because it is a premium service. Source: Kagan Research, LLC, *Economics of Basic Cable Networks 2005: Key Spreadsheets*, June 2004.

network revenue was 44 percent and the mean value was 41 percent.[15] It may be that some of the networks that receive nearly all or nearly none of their revenue from advertising hope to move away from these extremes over time. However, at any given time, as in this 2003 "snapshot," there are many networks at various points on this spectrum that would be affected differently by a decrease in advertising revenue.

**Table 2: Basic cable network advertising revenue as a percentage of total revenue**

| Advertising as a percentage of revenue | Number of networks |
|---|---|
| 0 – 9.99 | 15 |
| 10 – 19.99 | 5 |
| 20 – 29.99 | 10 |
| 30 – 39.99 | 18 |
| 40 – 49.99 | 15 |
| 50 – 59.99 | 23 |
| 60 – 69.99 | 10 |
| 70 – 79.99 | 7 |
| 80 - 89.99 | 2 |
| 90-100 | 2 |
| Total | 107 |

Advertising revenue is net of agency fees.

This diverse picture is much the same for networks of all sizes. For instance, among the networks that Kagan Research reports as having 80 million or more subscribers in 2003, the percent of revenue attributable to advertising ranged

[15] This is consistent with the GAO finding that "cable networks obtain roughly half of their overall revenues from advertising." (GAO, *Issues Related to Competition and Subscriber Rates in the Cable Television Industry*, October 2003, at 30.) It is not clear if GAO used net or gross advertising revenue in making its estimate.

from 83.7 percent (Home & Garden Television) down to 22.9 percent (American Movie Classics), and Disney with no advertising.

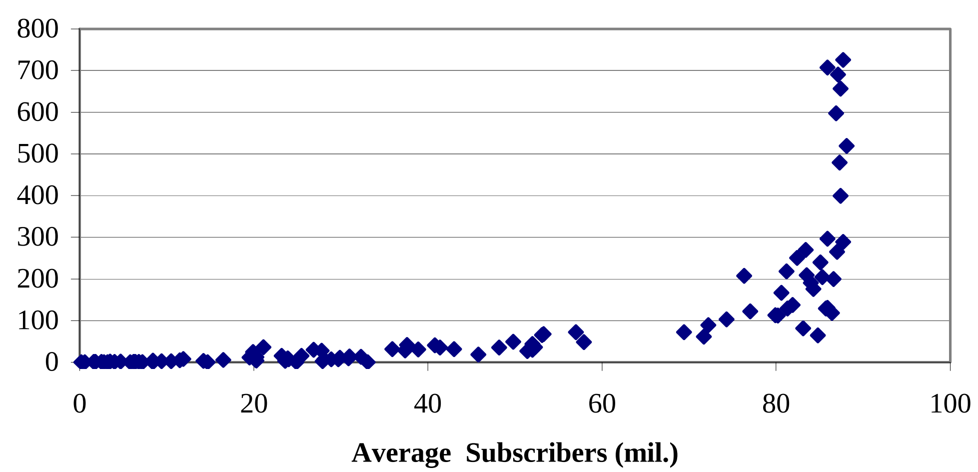
### 3. Variation in cable advertising rates and revenues

Two of the key factors in determining the advertising revenues of a basic cable network are its distribution (i.e., the number of subscribers to the programming tier that contains the network) and its viewership (as reflected in ratings or estimates of ratings). The network's distribution is the set of all consumers that have the opportunity to view the network at any given point in time. Some portion (in many cases a very small portion) of these potential viewers actually watch the network.

Network advertisers are interested in getting their messages to consumers. As the number of viewers that a network can provide increases or decreases, a network's value to advertisers and the revenue that a network receives from advertising likewise increases or decreases. Discussions with Viacom advertising sales personnel indicated that currently, as a rule of thumb, a cable network needs a subscriber base of approximately 50 million households in order to gain a significant amount of national advertising. One reason for this is that national advertisers prefer broad reach and it is at the 50 million subscriber level that the network is available to about half of all TV households. Additionally, national advertisers are interested in a network's ratings, and while Nielsen provides ratings information for networks starting at about 20 million to 30 million subscribers, the ratings numbers become more statistically reliable when a network reaches about 50 million subscribers. This is due to the fact that the Nielsen rating system is based on a sample of households. Fewer subscribers to a network means that there are likely fewer Nielsen households that report on the network, and as sample size decreases uncertainty increases.

Kagan Research has estimated the annual advertising revenue for 105 basic networks.[16] Figure 1 depicts net advertising revenue in 2003 for these 105 networks plotted against their subscriber bases. As Figure 1 makes clear, advertising revenue is not a linear function of tier subscribers.

**Figure 1: Network Net Ad Revenue ($ mil.)**

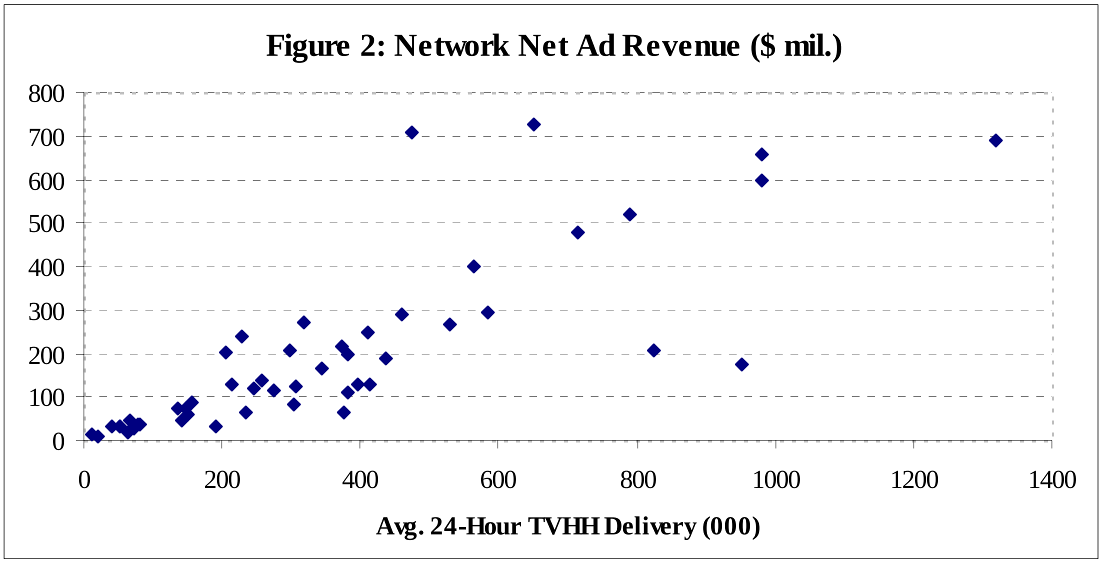



Though the size of the subscriber base is important, it is not the only factor explaining a network's advertising revenue. Figure 2 shows net advertising revenue plotted against the average 24-hour number of television households delivered for 49 cable networks.[17] This indicates that the number of households viewing a network is a key determinant of the network's advertising revenue. This

16 Kagan Research, LLC, *Economics of Basic Cable Networks 2005: Key Spreadsheets*, June 2004. This excludes those networks that do not sell advertising.

17 Id.

simple analysis does not hold constant the demographics or the desirability of the network's audience to advertisers.




**4. Impact of à la carte pricing on advertising revenue**

As discussed above, if a basic cable network were to be dropped by some MVPD systems, the number of actual viewers would likely decrease in about the same proportion as the decrease in the total subscriber base. However, in the case of a cable network being taken off a tier and offered à la carte, this assumption is not correct. At any positive price set by the MVPD, the consumers most likely to decline to take a network à la carte will be those who viewed the network least intensively when it was offered as part of a tier. Among the consumers who would be lost from the subscriber base are those that rarely or never watch the network and would pay only a modest amount to preserve their option to watch the network occasionally or for special events. If the MVPD's price for the network were somewhat higher, some consumers that previously viewed the network to a greater but still small extent would also choose not to subscribe à la carte. The viewers who choose to subscribe à la carte will include those who place a relatively high value on the network, and it is reasonable to assume (although of course not universally correct) that such viewers watch the network when offered on a tier more than the average tier subscriber.

For these reasons, the reduction in a network's subscriber base is likely to exceed, in percentage terms, the decline in its viewing audience. For a simplified hypothetical illustration, suppose that, when offered by MVPDs as part of a tier, Network X routinely attracts 500,000 viewing hours in the course of a 24-hour day. Suppose further that tier subscribers can be broken into eight equal-sized segments, each with differing propensities to watch the network. The number of average daily viewing hours coming from each segment is depicted in Table 3.

**Table 3: Viewing hours for a hypothetical tiered Network X, by subscriber segment**

| Segment | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | All |
|---|---|---|---|---|---|---|---|---|---|
| Viewing Hours | 0 | 0 | 0 | 25,000 | 50,000 | 75,000 | 150,000 | 200,000 | 500,000 |

Now suppose in this hypothetical illustration that 75 percent of Network X's subscriber base chooses not to subscribe when MVPDs offer the network à la carte. The 75 percent of subscribers who are lost will include all the subscriber segments that viewed the network seldom if ever. Segments 1-3 in Table 3 represent these subscribers. Segments 4-6 would also be lost, which would decrease average daily viewing hours by 150,000, or 30 percent of the initial 500,000 level.[18] The remaining two segments would provide a daily audience of 350,000 viewing hours. Thus, as a first approximation, a 75 percent decrease in the subscriber base of this hypothetical network would result in only a 30 percent reduction in viewing hours. As a rough estimate, advertising revenue would decrease by 30 percent in this hypothetical example. Of course the pattern of viewing across subscribers varies by network. Some cable networks may have most of their viewing concentrated within a small group of subscribers, while other networks may find their viewing is spread across a large group of subscribers. Reducing an audience is unlikely to increase CPMs. Many of the advertisers on a network sell products that appeal to a broad audience and purchase time in order to reach a broad audience. For such advertisers, there is little or no benefit, and perhaps a disadvantage, from reducing the audience. In addition, many networks are general interest networks and shrinking the audience for such a network probably would not change the overall make-up of the audience in a way that makes the audience more attractive to advertisers.

The loss of advertising revenue when moving to an unbundled environment may be more than proportional to the reduction in viewing. On a per-viewing-hour basis, the audience Network X offers advertisers in the à la carte environment will tend to be less valuable because it is smaller. As explained above, advertisers value unduplicated reach, and pay a premium for a larger audi-

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[18] This simplified hypothetical obviously omits other factors such as income that would affect which consumers choose to subscribe to a channel à la carte. It is not necessarily the case that all consumers who view a network at a low level would decline to take it à la carte, nor is it necessarily the case that all consumers that view a network most intensively would choose to take it à la carte.

ence. For this reason, a 10 percent increase in audience size will produce a greater than 10 percent increase in advertising revenue.[19]

Another aspect of advertising that would likely be affected by à la carte pricing is the ability of a "hit show" to be discovered and grow its audience. Part of the hit show phenomenon is that a program can quickly attract viewers. Many of these new viewers are likely to be infrequent viewers of the network, but nonetheless have access to it. When the network is part of a tier, these infrequent viewers can quickly and easily switch to the network and watch the program. After sampling the programming on the network, these viewers may then become more frequent viewers of the network. However, if the network were sold à la carte, there would be a longer delay and perhaps a smaller response because switching would now be more involved and the costs of switching would be higher. This would reduce the network's ability to generate audiences and advertising revenues from a hit show.

### *C. Other costs due to unbundling*

In addition to the possible reduction of advertising revenues, there are various costs that networks, MVPDs and consumers are likely to incur when cable networks are offered à la carte. This subsection examines the nature and magnitude of some of those additional costs based on data and information provided by

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[19] This effect was demonstrated empirically by Franklin M. Fisher, John J. McGowan and David S. Evans in "The audience-revenue relationship for local television stations," *The Bell Journal of Economics*, Autumn 1980, pp. 694-708.

Showtime Networks Inc. (a subsidiary of Viacom), which is attached as Appendix C.[20]

A cable network will face additional marketing costs, once unbundled, because it must now sell its programming to consumers as well as to MVPDs. The network must compete with dozens, if not hundreds, of other networks for the consumer's selection. MVPDs and consumers will face increased costs as well. Cable operator costs may increase due to the need for additional addressable converters, additional headend equipment, increased marketing costs, increased customer service costs, increased technical costs, and increased costs associated with customer ordering and billing. At least a portion of these increased costs will likely be passed on to subscribers. MVPDs will also likely face a reduction in advertising revenues due to fewer subscriptions.

Consumers will face increased search costs, as they must now learn about the various cable networks in order to determine which ones to select. Consumers will also face a probable loss of some existing networks and program services, a reduction in the number of new networks and program services entering the market, a lost option value to view infrequently watched programming on networks no longer subscribed to, and additional equipment costs. As the GAO pointed out, the need for subscribers to have an addressable converter box could be costly.[21] According to the FCC's 2002 cable rate survey, the average monthly rental price for a digital converter box and remote control is $4.87.[22] Subscribers with multi-

[20] Showtime Networks, *The Impact of A la Carte Pricing on Multichannel Video*, July 2004.

[21] GAO, *Issues Related to Competition and Subscriber Rates in the Cable Television Industry*, October 2003, at 32.

[22] FCC, *Report on Cable Industry Prices*, MM Docket No. 92-266, July 8, 2003, at Table 10.

ple television sets would need multiple converter boxes. The average American television household has about 2.5 televisions, and hence could face an equipment cost of over $12 per month in order to have access to à la carte networks.[23]

Currently, much of a cable network's marketing is directed at MVPD systems, with consumer-directed marketing designed to improve ratings for specific programs. However, in an à la carte regime, a network's marketing focus would need to change to the consumer to generate consumer demand for the network. The network as a whole would have to be marketed, not just specific programs. A cable network's additional costs would consist of transactional marketing expenses and the associated sales organization, business operations, human resources costs and associated auditing costs. Transactional marketing is a program of tactics, activities and resources designed to generate subscriptions to an à la carte network by stimulating consumer demand and influencing consumer choice at the point of sale. These tactics include consumer rebates, free previews, promotional offers, telemarketing, direct mail, customer contact personnel (CCP) sales incentives, CCP training and awareness tools, and distributor incentives to favorably price, package and promote the network such as volume and penetration discounts, retail price incentives and cash marketing support. In addition to these transactional marketing expenses, there are associated costs of the personnel needed to implement the transactional marketing program. For the most part, these transactional and associated marketing costs would be in addition to the existing advertising and marketing expenses incurred by a cable network. Indeed,

[23] Kagan Research, *Digital Television*, April 29, 2004, p. 5. Note that some households, particularly those subscribing to a direct broadcast satellite service, a digital tier of service, or a premium service, may already have a converter box for some of their television sets. These households would need a converter only for any television that is not currently equipped with a converter box.

advertising and marketing expenses may also increase in an à la carte regime as networks compete to get noticed by consumers.

Showtime Networks' analysis of the annual connects and transactional marketing expenses for the premium movie network category consists of Showtime Networks (Showtime, The Movie Channel, Flix), Home Box Office (HBO, Cinemax), and Starz Encore Group (Starz, Encore). Showtime Networks determined that the average annual transactional and associated marketing costs per connect for the premium network category as a whole is about $11.25.

This estimate is likely to be understated because $11.25 is the average cost when one premium network supplier is competing principally against only the other two existing major premium network suppliers. The transactional costs would likely be much higher if the network had to compete against the hundreds of other networks available on an unbundled basis. Moreover, the transaction costs likely would be higher as the recently unbundled networks scramble to attract initial subscribers. The $11.25 estimate is based on maintaining a given level of subscribers using the well-established marketing expertise of the premium networks. For these reasons, Showtime estimates that the average annual transactional and associated marketing costs per connect for an unbundled network would average about $16.90.

One way to estimate the total transactional and associated marketing costs that would be incurred were a cable network to be offered à la carte instead of as part of a tier is to consider the number of subscribers to the network and the churn rate. Churn is defined as the percentage of households that discontinue their subscription to the network each month. If a network wants to maintain its number of subscribers, much less grow, it must replace those subscribers it loses to churn.

Showtime Networks determined that the average monthly churn rate for Showtime, The Movie Channel, HBO, Cinemax and Starz is currently 5.9 percent.

Consider a network with 25 million à la carte subscribers. If the network's monthly churn rate is the same as that for those five premium networks, 5.9 percent, then the average annual "replacement" connects needed just to maintain the subscriber base are 17.7 million households. Using an estimate of $16.90 per connect, the annual transactional and associated marketing costs incurred by the network would be about $300 million just to maintain its subscription level of 25 million.

## V. Effects of unbundling on prices paid by subscribers

As noted above, one cannot confidently predict all the effects that would result from a change in the way that cable programming is sold to consumers. The retail bundling of cable networks is part of a complex system of interrelated economic decisions that involves program quality and marketing as well as pricing, as described above. In addition, the competitive interactions among networks are also important, as are the individual network pricing decisions made by the MVPDs.

The available evidence is not sufficient, even leaving aside the general disequilibrium into which the entire industry would be thrown by mandated unbundling, to predict exactly what prices would prevail for individual networks in a pure à la carte world. It does seem reasonable to expect, however, that any MVPD subscriber who sought to subscribe to the same array of networks now available on any given tier would pay more, and quite likely much more (because of the lost advertising support, decreased subscription revenue and increased marketing costs) to receive the current quantity and quality of programming, and that is indeed the result that emerges from the modeling exercise in this Section. The model indicates that consumers who subscribe to a moderate or large number of networks will end up paying more, while consumers who subscribe to only a few networks may pay less. However, in the longer run, there is no guarantee that the networks preferred by the latter group will remain in existence.

A complete general equilibrium model of consumer demand, network programmer supply, and MVPD system pricing is beyond the scope of this paper. But in order to provide some gauge of possible impact on consumer prices, we develop a simple model of the effect on subscriber prices of imposing à la carte. We do not check to see whether the resulting predictions of prices are consistent with a competitive equilibrium. While we have made some simplifying assumptions in order to arrive at our estimates, the results are nonetheless instructive.

The analysis that follows focuses on the 110 cable networks for which Kagan Research provides 2003 data.[24] The analysis begins with an assumption as to the percentage of current subscribers that would continue to subscribe if à la carte pricing were required. We have selected three different subscriber retention rates: 10 percent, 20 percent, and 30 percent.[25]

For the reasons discussed in Section IV.B, there is likely to be some loss of advertising revenue if unbundling is required. In order to account for the effect of lost advertising revenue on wholesale cable pricing, we have selected three different levels of advertising revenue retention: 80 percent, 60 percent, and 40 percent. Our assumption is that those consumers who continue to subscribe to a particular cable network under à la carte are the core viewers of the network. Hence, regardless of how many subscribers are retained, it is likely that the percentage loss in advertising revenue will be less than the percentage loss in subscribers.

As discussed in Section IV.C, programmers also are likely to incur additional marketing costs if à la carte pricing is imposed. In order to account for that effect on wholesale network pricing, we have estimated the additional transactional marketing and associated costs of each network. We assume that a network's monthly churn rate is the same as that for the existing premium networks, 5.9 percent, and that the average transactional marketing and associated costs are

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[24] Kagan Research, *Economics of Basic Cable Networks 2005: Key Spreadsheets*, June 2004.

[25] These values seem to cover the reasonable range of subscriber retention given the current take rates of the premium cable movie networks. See Appendix B.

about $16.90 per connect per year. Therefore, the additional expense the network incurs to replace those subscribers it loses to churn is about $1.00 per subscriber per month.[26]

In the real world, networks can respond to unbundling in a variety of ways. To facilitate an illustrative analysis, we assume that networks will raise license fees in order to offset any decline in subscriber or advertiser revenues and any increase in marketing costs, rather than lowering program expenditures. These assumptions permit us to calculate a network's wholesale price (license fee) to the MVPD systems. We then assume that MVPD systems apply a uniform 90 percent markup over wholesale price to calculate each network's à la carte retail price.[27]

Using these assumptions, we estimate à la carte retail prices for each of the 110 networks. We then compute the average price of a network under à la carte

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26 The annual cost to replace subscribers lost to churn equals $16.90 × 5.9% × 12 × subscribers. Therefore, the cost per subscriber per month equals $16.90 × 5.9%, or about $1.00.

27 The assumption of 90 percent markup appears to be in line with current MVPD markups. NCTA estimated 2003 basic cable subscriber revenue at $28.962 billion and 2003 premium subscriber revenue at $5.192 billion. (NCTA, *Cable Developments 2004*, p. 14.) Basic cable subscribers were reported at about 73.4 million in 2003. (NCTA, p. 8.) This implies basic and premium subscriber revenues of $38.79 per subscriber per month. In its 2002 cable industry survey, the FCC found that the average price of the basic service tier was $14.45. (FCC, *Report on Cable Industry Prices*, MM Docket No. 92-266, July 8, 2003, at Table 1.) This implies that subscribers paid about $24.34 per month for the programming beyond the basic service tier. Total cable programming expenditures, including license fees, copyright fees and investments in local original programming, was estimated at $11.46 billion, or $13.02 per basic subscriber per month. (NCTA, p. 13.) The markup of $11.33 over programming costs implies an estimated markup of 87 percent. This estimate understates the actual markup. The basic service tier often includes some basic networks, so some of the $14.45 should be considered payments to networks. The payment to networks or $13.02 is overstated because programming expenditures include local programming expenditures. Making these adjustments would increase the estimated markup.

pricing.[28] The results are presented in Table 4. For example, assuming that networks increase subscriber fees to recover lost subscriber and advertising revenue and increased transactional marketing costs, that networks retain 30 percent of their subscribers and 80 percent of their advertising revenue, and a 90 percent markup of the wholesale price, the average price of a network under à la carte pricing would be $3.39.

**Table 4: Weighted average retail price of a network under à la carte pricing**

| Advertising Revenue Retention | Subscriber Retention | | |
|---|---|---|---|
| | 30% | 20% | 10% |
| 80% | $3.39 | $4.13 | $6.37 |
| 60% | $3.61 | $4.46 | $7.03 |
| 40% | $3.83 | $4.79 | $7.70 |

As either the advertising revenue retention rate or the subscriber retention rate falls, the average price of a network increases. A decline in subscriber retention rates from 30 percent to 20 percent, holding the advertising revenue retention rate constant, increases the average price of a network by slightly less than $1.00, but a decline from 20 percent to 10 percent increase the average price of a network by over $2.00 to almost $3.00. If the advertising revenue retention rate declines from 80 percent to 60 percent, holding the subscriber retention rate constant, the average price of a network increases by 22 cents to 66 cents; a decline from 60 percent to 40 percent has the same effect.

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28 Throughout this section, the average price of a network is computed as the subscriber-weighted average price of the 110 networks included in the analysis. All prices reported are retail prices.

For comparison, consider that currently the average retail price of a network is $0.38.[29] Hence, after unbundling, the average retail price of a network is estimated to be 9 to 20 times higher than it is currently.

At the mid-point of the ranges considered—20 percent subscriber retention and 60 percent advertising revenue retention—the average price of a network is $4.46. At this price, the average cost per subscriber (exclusive of the basic tier fee and converter box fee) for 10 à la carte networks would be $44.60.[30] Adding the cost of the basic service tier and one converter box, the average consumer would pay $63.92 for basic service and 10 cable networks.[31] This is over 50 percent higher than the Commission's estimated 2002 average programming and equipment charge of $40.11 for basic service, equipment and 46 satellite delivered cable networks.[32]

It is possible that instead of raising license fees a network may respond by decreasing programming expenditures. However, any decrease in program quality is a cost to consumers, equivalent to a price increase. It is also quite possible that a network may not be able to recover from the decrease in revenues and increase in costs and may simply fail. Absent much better information on consumer de-

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29 This is based on Kagan Research's estimates of subscribers and license fees for each of the 110 networks, and assumes a 90 percent retail markup of license fees.

30 At least one study found that the average cable subscriber watches 12 to 15 channels. *See*, Concerned Women for America, "Cable Choice is Channel Choice," 2004. Since these channels probably included the broadcast networks, we use 10 cable networks in this example.

31 In its 2002 cable industry survey, the FCC found that the average price of the basic service tier was $14.45 and the average price of a digital converter box was $4.87. FCC, *Report on Cable Industry Prices*, MM Docket No. 92-266, July 8, 2003, at Tables 1 and 10.

32 Id.

mand for individual networks, as well as assumptions about the nature of and the path to the new industry equilibrium, it is not possible to predict which networks will fail. But it is reasonable to believe that at least some networks will be forced out of existence by unbundling.

### *C. Effect of unbundling on the number of cable networks*

Finally, a natural question is whether the overall number of cable networks will increase or decrease as a result of unbundling, and whether entry costs for new networks will increase or decrease. As with the issues addressed above, a more extensive and speculative modeling effort would be required to answer these questions precisely. It is clear, however, that the short-run or partial equilibrium effect of unbundling would be to reduce the number of networks and to increase entry costs. The number of networks would likely decrease because the models above predict both decreasing revenues and increasing costs for individual cable networks required to be unbundled. As is well known, many cable networks are, for a variety of reasons, unprofitable or marginally profitable. At least some of these networks will be forced out of existence by unbundling. Further, it is possible that there would be a reduction in aggregate expenditure on programming by the surviving networks, which would presumably result in a reduction in average program quality.

As to entry, it appears that new entrants would have a more difficult time than at present because tier subscribers would not be able to sample or "surf" their programs, but would instead have to commit to a network subscription. Overcoming this handicap would require increased expenditure on upfront and continuous advertising and promotion.

## VI. Other regulatory proposals – blocking and theme tiers

The preceding sections have discussed the economics of bundling and the consequences of requiring that MVPDs provide cable programming on an à la carte basis. We can now draw on this background to discuss other regulatory proposals and specific questions raised by some consumers and public officials.

### *A. Blocking*

One complaint that is sometimes made about tiers of programming offered by MVPDs is that some subscribers find objectionable programming bundled together with programming that they want. Of course, this can happen in any of the packages of media content that consumers purchase. *Time* or *Newsweek* may occasionally or even regularly contain material to which certain individuals object and which they do not want their children to see, even though they value the remainder of the content of the magazine and would encourage their children to read that content. The same may be true of local daily newspapers, of which most communities have but one. Consumers may have to make difficult decisions about whether to subscribe or not, and if they decide to subscribe they may need to take steps to protect their children from gaining access to the material that is objectionable. Similarly, consumers must decide whether to subscribe to MVPD bundles of content that contain objectionable material, and if they do subscribe they must take steps to prevent children from access to the objectionable material.

Consumers can take various steps to ensure that they do not watch these networks. Many set-top boxes, including most or all modern boxes, can be programmed to block specific networks, and some set-top boxes and televisions can block individual programs. Cable companies will, on request and for no additional charge, install a physical device outside the home that filters out or “traps” a specific network so it cannot be received. Consumers can also simply change the channel and not tune their televisions to the objectionable networks.

Some consumers who use a set-top box or "trap" to block a network ask why the fee they are charged by their MVPD is not reduced to reflect the reduced number of networks they are actually getting. However, ordinary consumer experience would not lead them to expect a fee reduction. As was pointed out above, sellers of all types bundle components together as products or services and provide them at a lower price than the sum of the cost of the individual components. A consumer who wants to buy a product that is not "off the shelf," customized either by including or excluding some features, often has to pay more. A diner ordering a steak may ask the restaurant to hold the baked potato that is "bundled" with the steak, but she does not expect the restaurant to decrease the price of the meal accordingly.[33]

The consumer who finds a network objectionable is not significantly different, in this regard, from a consumer who finds a network uninteresting. As pointed out above, most consumers have networks in their MVPD's programming tier that they do not watch. These consumers decide to subscribe to the MVPD's programming tier because, taken together, the networks that consumers do watch have a value that exceeds the price that the MVPD charges. They do not expect to

[33] As with any unbundling of content, blocking imposes costs on the MVPD and the cable network, as well as other subscribers. Returning to the magazine analogy from the Introduction Section, a subscriber could ask the publisher of *Newsweek* that a particular section dealing with foibles of celebrities be blacked out. Conceivably, the publisher might accommodate this request for a subscriber, or (more plausibly) even offer a redacted edition of the magazine if a significant percentage of subscribers had the same interest. However, both the costs and revenue effects of tailoring content in this way would likely, in a competitive environment, result in subscribers paying a higher price for the customized magazine, rather than receiving a discount because of the reduced content.

have their fee reduced to reflect the networks that they do not watch. Similarly, consumers who choose to subscribe even though they either block or do not watch certain objectionable networks find the value of the programming they do watch exceeds the price they have to pay, without any fee reduction.

The issue here arises not merely with MVPD bundling but with bundling of any kind. More specifically, suppose that a shopper needs exactly 12 ounces of bitter chocolate for a recipe. The store sells bitter chocolate in a 10-ounce bar for $2.00 (20¢ per ounce) and a 15-ounce bar for $2.25 (15¢ per ounce). The shopper buys the larger bar and later returns with the unneeded 3 ounces to the store, requesting a refund. Should the law require a refund in these circumstances? If so, how much should the refund be? What would happen to the cost of retail services and the prices of goods sold at retail if the law required a refund in these circumstances? It does not take much imagination to see that such a law would quickly produce a nightmare for suppliers and consumers alike.

In any event, it currently may not be economical or possibly even feasible for MVPDs to report reliably to a network the number of subscribers that block the network, especially if subscribers block the network using a set-top box. Thus, there is no mechanism for MVPDs to reduce their program acquisition fees when a consumer chooses to block. There is no cost savings for the MVPD to "pass through" to the consumer as a reduction in the consumer's monthly fee.

*B. Theme tiers and mixed bundling*

The Commission asks about the likely effects of mandating theme tiers. For example, there might be a sports tier, a movie tier, an adult tier, and/or a family tier. Presumably, material likely to be objectionable for children would be omitted from the family tier, for example. It is unclear who decides what program networks would be made part of such a tier. There are at least two problems with this approach. First, to the extent that MVPDs compete with one another (there are now at least three major MVPDs available to nearly every consumer, and sometimes other minor ones), a theme tier requirement would constrain the industry away from its competitive equilibrium. Policymakers generally accept the legitimacy of competitive market outcomes, if not because such outcomes optimize consumer welfare, then because there is no basis for improving matters with a regulatory intervention. In this case, forcing MVPDs to market their services in a way that differs from the strategy that best serves consumer demand seems likely to reduce economic welfare.

The second objection to a requirement of theme tiering is that it is not a content-neutral regulatory intervention. Indeed, the essence of the intervention is to organize content in a way different from the way the MVPD would like to organize and market it. This raises First Amendment issues that the Commission and the courts would have to address.

Government-mandated tiers would entail the same problems as à la carte pricing. Mandated tiers would reduce subscriber and advertising revenues because of reduced circulation for each network included on a tier that was not chosen by all current subscribers. Dividing the basic bundle into tiers would require consumers to pay for set-top boxes as with à la carte pricing of networks. Tiering would lead to increased marketing, transactional, and customer support service costs. Transactional costs may even be higher than with à la carte because a programmer would have to convince consumers to subscribe not to just its network, but to some tier of programming that will likely differ across MVPD systems. Indeed, a programmer's transactional expenditure will benefit not only itself, but whatever networks it is packaged with on the tier. Strategic interaction among networks in each tier might result in promotional expenditures greater or less than optimal levels.

Other proposals include "mixed bundling," whereby an MVPD must offer all the networks à la carte as well as in a bundle, and "voluntary" à la carte, whereby an MVPD can offer some networks à la carte rather than as part of a bundle. Again, breaking networks out of a tier taken by all subscribers would reduce a network's subscriber and advertising revenues because of reduced circulation for the network. Offering any of the networks à la carte would require consumers to pay for set-top boxes and would lead to increased marketing, transactional, and customer support service costs. [34] A program supplier's optimal promotional and marketing strategy and associated pricing decisions would likely differ if its network is sold à la carte rather than as part of a tier. If a programmer's network is offered à la carte in some areas and as part of a tier in other areas the programmer may need two different types of advertising and marketing campaigns. Indeed, the programmer may be in a difficult position because the programming would need to appeal to the à la carte consumer and to the tier consumer, and the optimal type of programming to reach theses two types of consumers may be different. There could also be problems in selling national advertising. Hence, a cable network may not be able to survive in competition if its program service is not marketed uniformly (i.e., on the same type of tier) by all MVPDs.

Being forced to unbundle only a few specific networks will create the problems discussed above for those networks that are unbundled and might not

[34] In a mixed bundling regime, consumers who subscribe to the bundle may not need a converter box.

reduce the price of the remaining bundle of networks. To the extent that certain subscribers are willing to pay only a very low price for the networks that are unbundled, the price they are willing to pay for the remaining bundle of networks is unchanged or only slightly reduced. If there are many such subscribers, the MVPD will not significantly reduce the price of the bundle. Since these consumers were initially purchasing the bundle to view networks other than the networks that were unbundled they should be willing to pay the same price for the bundle excluding those networks.

## VII. Conclusion

We conclude that mandatory unbundling of cable program services at the wholesale or retail level would be harmful to consumer welfare in the United States. At the wholesale level the evidence suggests that bundling simply is not an important feature of the commercial landscape. Where buyers do perceive it to occur, they probably mistake what amounts to a quantity discount for a true bundled offer. At the retail level, complaints about bundling may reflect the false assumption that the sum of the competitive prices for unbundled networks would be the same as current bundle prices. As we have shown, the reality is that the components would likely cost more than the bundle. More generally, bundling is a very common and efficiency-enhancing economic phenomenon. In its absence, costs and prices would increase, making virtually everyone worse off and reducing the output of goods and services.

Even if all of the foregoing is assumed to be incorrect, so that bundling actually reduced welfare in the MVPD programming markets, remedial action would be elusive. Bundling is in part a pricing phenomenon, and it could not be limited without regulating both the definition of what constitutes a bundle for each product or service as well as its price. In contrast to the task of regulating unbundled elements of local exchange services, where the conditions for efficient pricing are relatively straightforward, there is no generally accepted rule for pricing non-rivalrous consumption goods such as video programming that is incentive compatible on the supply side and efficient on the demand side.

## Appendix A. Basic cable networks included in each network supplier

| Network supplier | Cable networks |
|---|---|
| A&E | Arts & Entertainment, Biography, History Channel, History Channel International |
| Cablevision | American Movie Classics, Fuse, Independent Film Channel, Women’s Entertainment |
| Comcast | E! Entertainment Television, Golf Channel, Outdoor Life Network, Style. |
| Discovery | Animal Planet, Discovery Channel, Discovery en Espanol, Discovery Health Channel, Discovery Home Channel, Discovery Kids Channel, Discovery Science Channel, Discovery Times Channel, Discovery Wings Channel, The Learning Channel, Travel Channel. (FitTV was not included because it was acquired in 2001 and re-launched in 2004.) |
| Disney | ABC Family Channel, Disney Channel, ESPN, ESPN2, ESPN Classic Sports, ESPNews, SoapNet, Toon Disney |
| Fox | Fox Movie Channel, Fox News Channel, FX, Speed Channel (National Geographic Channel was not included because it started in 2001.) |
| Lifetime | Lifetime, Lifetime Movie Network (Lifetime Real Women was not included because it started in 2001.) |
| Time Warner | Cartoon Network, CNN, CNNfn, Headline News, NBA.com TV, TBS Superstation, Turner Classic Movies, Turner Network TV |
| Viacom | BET, BET Jazz, CMT: Country Music Television, Comedy Central, MTV: Music Television, MTV Espanol, MTV2, Nickelodeon/Nick at Nite, Nickelodeon GAS, Noggin, Spike TV, TV Land, VH1, VH1 Classic, VH1 Country, VH1 Soul. |

## Appendix B

## Demand evidence

### Economic literature

Recent economic studies have attempted to estimate mean consumer willingness to pay for basic cable networks while accounting for the differences among networks.[35] One study estimates the price of the basic cable bundle when different cable networks are added.[36] The study assigns cable networks to various groups (news, sports, family, etc.) and then estimates the common value of any member within a group. Using nearly fifteen-year-old subscriber data (from 1990), this study finds that the addition of a family or sports network increased the price of basic cable by 7 percent while the addition of a music, news, or educational network increased the price by 4 percent. At $15.90, the average basic

35 Earlier economic literature focused on the incremental price charged by cable operators when they included an additional cable network. No distinction was made for the type of network added. Incremental values found ranged from a few cents per month to less than a dollar per month. These results most likely do not provide a useful guide to optimal à la carte prices for a number of reasons. First, there is no variation in the value of different cable networks. It is likely that some cable networks are more valuable to consumers than others (some may even have negative values for a portion of subscribers). Averaging consumer value over all cable networks will mask this variation. Second, these studies attempt to determine the incremental value consumers place on a cable network when it is *included in* the basic or expanded basic bundle. This value is certainly affected by the other choices already available within the bundle. This is especially problematic when the value estimated is for an additional generic cable network. Third, these studies make no allowance for non-subscriber revenue to cable systems. Fourth, the studies do not control for variation in cable system programming acquisition costs. Cable systems not only take into consideration consumer demand and advertising revenue, they also account for the cost of the programming. There are obviously wide differences in carriage fees paid by cable systems that must be included in any model of consumer demand.

36 Diane Anstine, "How Much Will Consumers Pay? A Hedonic Analysis of the Cable Television Industry," *Review of Industrial Organization*, Number 19, pp. 129-147, 2001.

cable price in the sample, this would imply an increase in price of $1.11 and $0.67 respectively.[37] The use of categories of networks was required because the author was unable to get statistically significant results when using individual cable networks.

The estimates of consumer value derived in this study are of limited value for estimating optimal cable network à la carte pricing for several reasons. First, values are not derived for particular networks, but for each of the 15 categories of networks defined by the author. Second, the value of the network is determined when *added* to the basic bundle. This may not be the same value assigned to the network *outside* of any bundle. Third, the study estimates the average value across all consumers and does not indicate how the value varies across consumers—i.e., the results do not describe demand curves.

In a series of papers by Gregory Crawford, consumers' mean willingness to pay is estimated for particular networks.[38] Professor Crawford and his co-authors use carriage variation across cable systems to estimate the mean willingness to pay for the top 15 cable networks (based on total subscribers). Using data from 1992 and 1995, these studies find that the mean willingness to pay varies

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37 Anstine finds that the addition of general program networks and superstations adds no significant value. The author speculates that this is due to the similarity between those networks and over-the-air programming.

38 "The Impact of the 1992 Cable Act on Household Demand and Welfare," Gregory S. Crawford, *Rand Journal of Economics*, Vol. 31, No. 3, Autumn 2000, pp. 422-449. "The Discriminatory Incentives to Bundle in the Cable Television Industry," Gregory S. Crawford, Working Paper, University of Arizona, April 2, 2004, "Bundling in Cable Television: Incentives and Implications for Regulatory Policy," Mark Coppejans, Gregory Crawford, Duke University Working Paper [Draft], November 1999.

from a high of $5.50 for ESPN to a low of -$1.22 for the Family network.[39] Even though the authors have estimated values for particular cable networks, these estimates retain some of the unsuitable features of the previous study for purposes of estimating prices under à la carte pricing.

**Inferences from premium services**

A limited amount of information about consumer choice and prices can be gleaned from premium networks that are now offered à la carte. Data from Warren Communications show, for many cable systems, the number of subscribers taking individual premium networks and the monthly fee charged by the cable operator for that network. Usable data were available for HBO on 3,416 systems, for Cinemax on 1,944 systems and for Showtime on 1,922 systems.[40]

To study thoroughly the effect of price on subscription levels, one would want to control for economic and demographic characteristics of MVPD systems' service areas, the price and quality of basic service, the number of broadcast signals available, and other relevant factors. Such a study is not feasible within the time available to respond to the Public Notice. Nonetheless, some rough observations may be useful in calibrating the analysis of prices and subscription levels that might be expected among basic networks in an à la carte environment.

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39 Negative values are possible since the authors are measuring mean willingness to pay. The network may still have positive value to the bundle if some subscribers value it highly.

40 Systems were excluded if they did not carry a particular network, if there was no fee reported to receive that network alone (as opposed to a bundle of premium networks), if no subscriber counts were reported, or if the reported number of subscribers to the premium service exceeded the number of basic subscribers reported for the system.

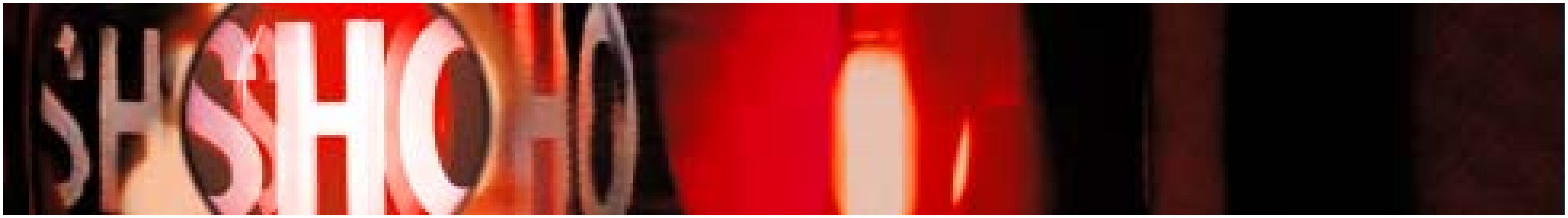
Among the systems providing useable data:

- Ninety-three percent of HBO subscribers pay between $8.00 and $14.00 per month. At each dollar interval in that range, the ratio of HBO subscribers to total basic subscribers was calculated for all systems offering HBO at a price in that range. For instance, among systems offering HBO for $8.00-$9.00, 21.5 percent of total basic subscribers were also HBO subscribers. Across different dollar price intervals, the percentage of basic subscribers taking HBO, or the "take rate," reached a low of 20.2 percent and a high of 23.4 percent. The average take rate among subscribers in all systems pricing in the $8.00-$14.00 range was 21.7 percent, at an average price of $11.47.
- Again, ninety-three percent of Showtime subscribers pay between $7.00 and $14.00 per month. Across different dollar price intervals, the Showtime take rate ranged between 9.5 percent and 22.9 percent. The average take rate among subscribers in all systems pricing in the $7.00-$14.00 range was 10.6 percent, at an average price $10.95.
- Ninety-five percent of Cinemax subscribers pay between $7.00 and 14.00 per month. Across different dollar price intervals, the Cinemax take rate ranged between 9.2 percent and 11.4 percent. The average take rate among subscribers in all systems pricing in the $7.00-$14.00 range was 10.3 percent, at an average price of $10.84.

Care must be taken in applying even these limited conclusions to the likely prices and take rates for basic cable networks if they were to be sold à la carte. The numbers of consumers that choose to subscribe to a premium service will depend not only on the price of the service, as just discussed, but also on the price and availability of other alternative programming. Extrapolating these results to basic networks also requires that account be taken of the differences in programming genre on premium networks (principally recent movies and original programming) and programming on basic networks (either general interest or niche programming). Additionally, the premium networks do not rely on any advertising revenue, and subscribers pay a higher fee because of this. One also has to control for the quality of the programming.

In sum, the available evidence is not sufficient, even leaving aside the general disequilibrium into which the entire industry would be thrown, to predict the demand for individual channels in a pure à la carte world. It does seem reasonable to expect, however, that there will be a decrease in the number of subscribers to any current network. Moreover, the number of subscribers that a network retains is likely to be correlated with the number of households currently viewing the network.

# Appendix C



# The Impact of A la Carte Pricing On Multichannel Video

July 2004

Showtime Networks Research & Analysis

# Summary

- ***Up to <u>$60 billion</u>*** per year in incremental transactional and related marketing costs would be incurred by programmers in an a la carte pricing scenario
- A la carte pricing requires tremendous transactional marketing* in order to attract and retain subscribers

* For the purposes of this discussion, transactional marketing is defined as a program of tactics, activities and resources designed to generate subscriptions to an a la carte network by stimulating consumer demand and influencing consumer choice at the point of sale. These tactics include, but are not limited to, consumer rebates, free previews, promotional offers, telemarketing, direct mail, customer contact personnel (CCP) sales incentives, CCP trainings and awareness tools, and distributor incentives to favorably price, package and promote the network such as penetration discounts, retail price incentives, cash marketing support.

# Premium Business Overview

- There are three companies in the premium category
  - Showtime Networks Inc. (Showtime, The Movie Channel)
  - Home Box Office, Inc. (HBO, Cinemax)
  - Starz Encore Group LLC (Starz)
- Annual premium retail revenue for cable and DBS is $8.2 billion
- Total premium households in cable and DBS is 31.2MM
  - Among the five premium services, there are 74.4MM premium units
- As an a la carte video service, premium is much more 'transactional' than basic cable
  - Requires significant marketing and operational support*

* Transactional marketing as defined on previous page, plus related sales organization, business operations/finance infrastructure.

Source: Premium and household and unit estimates from Kagan Research, LLC, 4/04, Nielsen Homevideo Index, 11/03; revenue estimates from Deustche Bank, 3/04 and 5/04.

# Annual Premium Category Connects & Marketing

| | |
|---|---|
| Cable & DBS Total Premium Households (December 2003) | 31.2MM |
| Average Monthly Household Churn Rate | 5.9% |
| **Annual Premium Household 'Replacement' Connects Required *Just to Stay Even*** | **22.1MM** |
| **Annual Premium Unit 'Replacement' Connects Required *Just to Stay Even*** | **41.6MM** |
| Annual Premium 'Transactional' Marketing Expense | $240.4MM |
| Annual Premium Addl. Marketing Expense | $227.9MM |
| **Total Annual Premium Sales, Marketing & Advert Expense** | **$468.3MM** |
| Average Cost per Unit Connect | $11.25 |

Source: Third party public filings and equity research reports; churn and connect estimates derived from SNI Sales & Marketing analysis; Kagan Research, LLC premium HH estimates; Nielsen Homevideo Index, 11/03.

# Additional Costs From Making All Video Services Available A la Carte

For Programmers:

- Reduced advertising revenue
- More branding/advertising required
- Higher programming investment
- Greater costs and complexity associated with
  - Subscriber reporting administration
  - Collections and accounting
  - Affiliate auditing
- Additional Sales personnel and corresponding increase in overhead required
- Training costs for Sales Personnel
- Transactional marketing expenses

SHOWTIME UNLIMITED

# Additional Costs From Making All Video Services Available A la Carte

For Distributors:

- Digital set-top box required for every TV
- Billing system upgrades
- Signal transmission/bandwidth management inefficiencies
- Higher license fees from programmers
- Reduced local advertising revenue
- Capital investment in new Call Center facilities
- Training costs for Customer Contact Personnel (CCP)
- More phone time per call for CCP
- More customer confusion and dissatisfaction

# Basic Networks Could Incur up to $300MM in Annual Transactional and Related Marketing Expense, Which is Not Currently Part of Their Operating Budget

**Estimated Additional Costs with Total A la Carte Pricing**
**(based on the current Premium business)**

## For A Typical* Network

| | Current | A la Carte |
|---|---|---|
| Average Annual Connects | 17.8MM | 17.8MM |
| Average Cost Per Connect | $11.25 | $16.90 |
| Annual Transactional & Related Marketing Expense | $200.3MM | $300.8MM |

* Connect volume is based on a network with 25% subscriber penetration of multichannel video universe.
Increased cost per connect estimate derived from SNI analysis; cost may vary.

# What Would Consumers Have to Pay?

**Building on Bear Stearns' analysis, we have added transactional marketing costs to the impact of a la carte on the estimated cost to consumer. In this case, in order to preserve current revenue, TBS might cost as much as $5.20 if its penetration dropped to 25% in an a la carte scenario.**

| *($ and subscribers in millions, except per subscriber data)* | TBS* | | | |
|---|---|---|---|---|
| | | Take Rate | | |
| | Current | 75% | 50% | 25% |
| Subscribers | 88.6 | 66.5 | 44.3 | 22.2 |
| Subscription Revenue | $252 | $252 | $252 | $252 |
| Advertising Revenue | 553 | 507 | 461 | 415 |
| Incremental Subscription Fee from Loss of Advertising (1) | 0 | 46 | 92 | 138 |
| Total Subscription and Advertising Revenue | $805 | $805 | $805 | $805 |
| Increase in Transactional Mktg Costs | 0 | $904 | $602 | $301 |
| Monthly Wholesale Subscription Fee per Sub to maintain Subscription Revenue | $0.24 | $0.32 | $0.47 | $0.95 |
| Monthly Incremental Subscription Fee from Loss of Advertising | 0 | 0.06 | 0.17 | 0.52 |
| Monthly Incremental Subscription Fee from Increase in Mktg Costs | 0.00 | 1.13 | 1.13 | 1.13 |
| New Monthly Wholesale Subscription Fee per Subscriber | $0.24 | $1.51 | $1.78 | $2.60 |
| Estimated Cost to Consumer (2) | $0.47 | $3.02 | $3.56 | $5.20 |

* TBS was selected as one of the five network examples Bear Stearns analyzed for illustrative purposes. (1) Bear Stearns assumes 33% of the subscriber reductions impact ad revenue (i.e., a 50% take rate would translate into a 16.7% reduction in ad revenue). (2) SNI assumes a 50% gross margin on the wholesale subscription fee for the cable operator (i.e., a 100% mark-up to the wholesale cost).

SHOWTIME UNLIMITED

Source: Bear Stearns & Co., Inc., *A La Smart?,* March 29, 2004, plus SNI analysis of transactional marketing costs.

# What Would Consumers Have to Pay?

**Building on Bear Stearns' analysis, we have added transactional marketing costs to the impact of a la carte on the estimated cost to consumer. In this case, in order to preserve current revenue, ESPN might cost as much as $18.77 if its penetration dropped to 25% in an a la carte scenario.**

| | ESPN* | | | |
|---|---|---|---|---|
| *($ and subscribers in millions, except per subscriber data)* | | Take Rate | | |
| | Current | 75% | 50% | 25% |
| Subscribers | 88.7 | 66.5 | 44.4 | 22.2 |
| Subscription Revenue | $2,012 | $2,012 | $2,012 | $2,012 |
| Advertising Revenue | 737 | 676 | 614 | 553 |
| Incremental Subscription Fee from Loss of Advertising (1) | 0 | 61 | 123 | 184 |
| Total Subscription and Advertising Revenue | $2,749 | $2,749 | $2,749 | $2,749 |
| Increase in Transactional Mktg Costs | 0 | $904 | $603 | $301 |
| Monthly Wholesale Subscription Fee per Sub to maintain Subscription Revenue | $1.89 | $2.52 | $3.78 | $7.56 |
| Monthly Incremental Subscription Fee from Loss of Advertising | 0 | 0.08 | 0.23 | 0.69 |
| Monthly Incremental Subscription Fee from Increase in Mktg Costs | 0.00 | 1.13 | 1.13 | 1.13 |
| New Monthly Wholesale Subscription Fee per Subscriber | $1.89 | $3.73 | $5.15 | $9.38 |
| Estimated Cost to Consumer (2) | $3.78 | $7.46 | $10.29 | $18.77 |

* ESPN was selected as one of the five network examples Bear Stearns analyzed for illustrative purposes. (1) Bear Stearns assumes 33% of the subscriber reductions impact ad revenue (i.e., a 50% take rate would translate into a 16.7% reduction in ad revenue). (2) SNI assumes a 50% gross margin on the wholesale subscription fee for the cable operator (i.e., a 100% mark-up to the wholesale cost).

Source: Bear Stearns & Co., Inc., *A La Smart?,* March 29, 2004, plus SNI analysis of transactional marketing costs.

# Estimated Additional Costs with Total A la Carte Pricing (based on the current Premium business)

## For Distributors

| | A la Carte | Increase |
|---|---|---|
| Annual Video Installs/Disconnects | 51.4MM | N/C |
| Annual Video 'Service Adjustments'* | 38.6MM | 22.2MM |
| Annual CCP Phone Hours Required | 5.2MM | 4.1MM |
| Annual CCP Expense | $244.0MM | $128.0MM |

* Service adjustments are changes to existing premium or digital service subscription, such as adding services, dropping services, or substituting one service for another. A la carte is projected to increase the complexity and duration of service adjustment phone calls, as consumers inquire about their new options, and evaluate cost savings with more extensive assistance from CCP.

Source: SNI Sales & Marketing analysis; CCP phone expense averages from 2003 CCP industry conference guide.

**Before the**
**FEDERAL COMMUNICATIONS COMMISSION**
**Washington, D.C. 20554**

| | |
|---|---|
| In the Matter of:<br><br>À La Carte and Themed Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems | <br><br>MB Docket No. 04-207 |

# REPLY COMMENTS OF VIACOM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August 13, 2004

## SUMMARY

The vast majority of commenters to this proceeding overwhelmingly confirm that an à la carte or themed tiering mandate is unnecessary and, in fact, would be highly detrimental to the public interest. Parties representing a full range of interests—from independent and vertically integrated programmers, to MVPDs of all sizes, to public interest organizations, to federal, state, and local government representatives—demonstrate that any requirement to carry program services on an à la carte basis would dramatically raise costs for consumers at the same time that it would decrease both the quality and the variety of services available to them. Notably, a number of parties representing specialized and minority interests—the alleged beneficiaries of an à la carte regime—stress that an à la carte system would directly and substantially threaten the viability of niche-oriented program services.

Even those few parties advocating some form of regulation emphasize the negative consequences of mandating the provision of à la carte services to consumers and vehemently argue that they themselves should not be subject to any form of regulation. Instead, these parties seek to impose a broad array of regulations on programmers that would give distributors the "flexibility" to provide à la carte services. These requests for so-called "voluntary" à la carte are misleading. The regulations suggested by these parties would not be "voluntary" at all for programmers. In any case, these same parties have supplied a long list of reasons why the provision of per-channel services to subscribers would have dire consequences for their business models and ultimately would harm consumers.

The suggestion of a few parties that an à la carte option would save consumers from being forced to pay a "tax" for unwanted program services misses the mark entirely. As has clearly been demonstrated in this proceeding, the current program distribution system is highly

efficient for all consumers. The distribution of crayons in multi-color boxes illustrates the point. By combining popular and a range of more specialized colors into a single box, crayon distributors make the entire package more appealing for consumers as a whole—even though individual consumers inevitably will not have a use for some of the colors in each box. The arrangement also reduces the costs that would be associated with distributing individually packaged crayons. In this manner, the vast majority of consumers are able to receive the colors they do want at a relatively low cost. The distribution of program services in packages is efficient for consumers in essentially the same way.

A handful of parties call for a series of intrusive constraints on the marketplace negotiations for retransmission consent. In particular, this small minority of distributors claims that requiring carriage of new networks in exchange for retransmission consent is anticompetitive. In fact, the practice of exchanging carriage of affiliated program services for retransmission consent is a longstanding one in the video programming industry that was initiated at the behest of MVPDs. At the time, cable operators found that providing distribution for new networks could provide television broadcasters with value for their signals at lower cost than cash compensation. Moreover, the FCC repeatedly has endorsed this practice as "consistent with competitive marketplace considerations."

Antitrust analysis does not suggest otherwise. With hundreds of cable networks up and operating in today's marketplace, it is clear that the cable programming market is strong, vibrant, and competitive and that the adverse effect on competition prohibited by the antitrust laws simply does not exist. Accordingly, there is absolutely no need to eradicate the careful balance that Congress and the Commission have struck in crafting the existing retransmission consent policies.

In addition to their requests to essentially repeal the retransmission consent rules, several parties ask the FCC to further weaken broadcasters' rights to negotiate for carriage of their local signals by reciting their time-worn requests to expand the program access rules to non-vertically integrated programmers, including broadcasters.  Again, these parties show no competitive basis for such far-reaching changes to this regulatory scheme, which was designed only to address potential problems created by the vertical integration of cable operators and programmers.

In sum, based on the great weight of the evidence in this proceeding, Viacom respectfully submits that the Commission recommend to Congress that the creation of mandatory à la carte regulations, at either the wholesale or retail level, would be unnecessary and highly counterproductive for consumers.

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**Washington, D.C. 20554**

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## REPLY COMMENTS OF VIACOM

### I. THE WEIGHT OF THE EVIDENCE IN THIS PROCEEDING CONFIRMS THAT THERE IS NO BASIS FOR AN À LA CARTE OR THEMED TIERING MANDATE

The vast majority of commenters to this proceeding have stated that regulations imposing à la carte or themed tiering requirements would have adverse consequences for all segments of the video programming industry and, ultimately, for consumers. Tellingly, even those few parties advocating some form of regulation point out the negative consequences of mandating the provision of à la carte services to consumers and vehemently argue that they themselves should not be subject to any form of regulation. What these parties ask for, instead, is the imposition of a series of onerous regulations on programmers that would give distributors the "flexibility" to provide à la carte services that many apparently have no intention of offering to consumers and that simply would transfer value from programmers to MVPDs. As explained herein, the suggestion that the FCC recommend regulations enabling a so-called "voluntary" à la carte system is both disingenuous and devoid of factual and economic support.

### A. Commenters Representing A Full Range Of Interests Overwhelmingly Agree That Such Regulation Would Be Detrimental To The Public Interest

Independent and vertically integrated programmers, multichannel video programming distributors ("MVPDs") of all sizes, public interest organizations, government officials, and individual consumers alike recognize the inherent benefits in the current system of program packaging and distribution and acknowledge that an à la carte or themed tiering mandate would significantly and needlessly threaten this well-functioning system to the detriment of consumers. The large array of network programmers that have weighed in on this proceeding almost universally agree that bundling services into tiers has enabled an incredible diversity of program services to launch and thrive. By contrast, an à la carte regime would undermine the ability of these services to garner the viewership, subscription revenues, and advertising revenue needed to remain viable.[1] Many of these programmers further point out that, under an à la carte or themed tier regime, their marketing expenses would skyrocket as they begin to incur the huge costs

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[1] *See* A&E Television Networks Comments at iii-v; Bloomberg Television Comments at 2-3 ("Bloomberg Comments"); Courtroom Television Network LLC Comments at iii-v; C-SPAN Networks Comments at 1-5 ("C-SPAN Comments"); Discovery Communications, Inc. Comments at iii-v ("Discovery Comments"); Eternal Word Television Networks, Inc. Comments at 2-6 ("Eternal Word Comments"); Fox Cable Networks Group Comments at i-iv ("Fox Cable Comments"); GSN—The Network for Games Comments at 2-8 ("GSN Comments"); Hallmark Channel Comments at 2-12; International Cable Channels Partnership, Ltd. Comments at 1 ("International Networks Comments"); Joint Commenters—Altitude Sports & Entertainment, *et al.* Comments at i-v ("Altitude Sports Comments"); LAtv Holdings, LLC Comments at 1-2 ("LAtv Comments"); LeSEA Broadcasting Corporation, Inc., *et al*. Comments at 4-7 ("LeSEA Comments"); Lifetime Entertainment Services Comments at 3-8; MBC Gospel Network LLC Comments at 1-9 ("MBC Network Comments"); NBC Universal, Inc. Comments at 1-8; Oxygen Media Corporation Comments at 2-8 ("Oxygen Comments"); Scripps Networks, Inc. Comments at 1-5; Starz Encore Group LLC Comments at 2-6 ("Starz Comments"); TelAlaska, Inc. Comments at 2-3; Turner Broadcasting System, Inc. Comments at 1-2; TV One Comments at 1-3; Univision Communications Inc. Comments at i ("Univision Comments"); Viacom Comments at 1-3; Walt Disney Company Comments at 2-3 ("Disney Comments"); and Weather Channel, Inc. Comments at 1-2. (Unless indicated otherwise, all comments cited herein were submitted in MB Docket No. 04-207 on July 15, 2004.)

inherent in broad-scale direct-to-consumer retail sales.[2] Detailed economic analyses consistently demonstrate that, in the end, consumers would face sharp price increases as well as a considerable drop in program diversity and quality.[3] Importantly, these concerns are voiced not only by the most widely viewed networks, but also by a broad range of independent, niche, religious, and minority-oriented programmers.[4]

Both large-scale and smaller MVPDs note that under the present system they have strong incentives to deliver appealing services to consumers in the most efficient manner possible.[5] In particular, MVPDs point out that à la carte requirements would be fraught with technical challenges and would entail substantial marketing, billing, and other operational expenses that would drive up consumer costs considerably.[6] Moreover, even MVPD proponents of some form of regulation, such as EchoStar and the American Cable Association, recognize that mandating the provision of à la carte services to subscribers would needlessly hinder their business operations and have negative consequences for consumers.[7]

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[2] *See, e.g.*, Bloomberg Comments at 10-11; C-SPAN Comments at 4-5; GSN Comments at 7-8; Hallmark Channel Comments at 7-8; Altitude Sports Comments at 56-58; Oxygen Media Comments at 6; Starz Comments at 2-6; TV One Comments at 2; Disney Comments at 2, 18.

[3] *See* Comcast Corporation Comments, Appendix A ("Comcast Comments"); Insight Communications Company, Inc. Comments, Exhibit B ("Insight Comments"); National Cable & Telecommunications Association Comments, Exhibit A ("NCTA Comments"); Discovery Comments, Exhibit A; Disney Comments, Exhibits 1, 2; Fox Cable Comments, Appendix A; Viacom Comments, Attachment 1.

[4] *See, e.g.*, LAtv Comments at 2-8; Univision Comments at 9-17; MBC Network Comments at 4-9; TV One Comments at 1-3; International Networks Comments at 5-9; Eternal Word Comments at 2-6; LeSEA Comments at 4-7; Oxygen Comments; Scripps Networks Comments at 16-22.

[5] *See* Advance/Newhouse Communications Comments at 1-3; Charter Communications, Inc. Comments at i-ii; Time Warner Cable Inc. Comments at 1-2 ("Time Warner Comments"); Comcast Comments at i-ii; NCTA Comments at 4-5.

[6] *See, e.g.*, The DIRECTV Group, Inc. Comments at 5-8; Smaller Operators Comments at 5-10; Insight Comments at 4-22; NCTA Comments at 27-28; Time Warner Comments at 8-9.

[7] *See* EchoStar Satellite LLC Comments at 1, 3-4 ("EchoStar Comments"); American Cable Association Comments at 6-7 ("ACA Comments"); Broadband Service Providers Association Comments at 10 ("BSPA

A wide assortment of public interest organizations, private citizens, and federal, state, and local government representatives raise similar objections. Notably, several public interest groups representing minority interests express concern that à la carte or themed tiering obligations would pose a substantial threat to the creation and success of niche services, particularly to those services operating independently and representing minority viewpoints.[8] In addition, dozens of elected officials have written letters to Congress and the Commission detailing the adverse consequences that an à la carte mandate would have on diversity and consumers, generally concluding that such obligations would be a "classic case of a solution that is far worse than any perceived problem."[9] Finally, despite the facial appeal of being able to select networks on a per-channel basis, individual consumers recognize the disadvantages that an à la carte mandate

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Comments"); CT Communications Network, Inc. Comments, *et al.* at 12-13 ("CT Communications Comments"); Discovery Comments at 4-21.

8 *See, e.g.*, The American Center for Law and Justice Comments at 9-13; Leadership Conference on Civil Rights Comments at 3-7; *see also* Letter from Dr. E. DeLores Tucker, National Chair, National Congress of Black Women, to Marlene H. Dortch, Secretary, FCC (June 28, 2004); Letter from Lorraine Cortes-Vazquez, President, Hispanic Federation, to Michael K. Powell, Chairman, FCC (June 30, 2004); Letter from Antonio Gonzalez, President, William C. Velasquez Institute, to Michael K. Powell, Chairman, FCC (July 1, 2004); Letter from Marc H. Morial, President & CEO, National Urban League, to Marlene H. Dortch, Secretary, FCC (July 7, 2004); Letter from Gabriela Lemus, Director of Policy and Legislation, League of United Latin American Citizens, to Michael K. Powell, Chairman, FCC (July 7, 2004); Letter from Rev. Wille Barrow, Rainbow/PUSH Coalition, to Marlene H. Dortch, Secretary, FCC (July 9, 2004); Letter from Alvin Brown, Chairman, National Black MBA Association, to Marlene H. Dortch, Secretary, FCC (July 9, 2004); Letter from Guarione M. Diaz, President, Cuban American National Council, to Michael K. Powell, Chairman, FCC (July 14, 2004); Comments of The Women's Alliance (July 20, 2004); Comments of New York Women in Film and Television (July 22, 2004); Comments of The American Business Women's Association (July 23, 2004).

9 *See* Letter from Harvey C. Johnson, Mayor, Jackson, Mississippi, to Joe Barton and John Dingell, U.S. House of Representatives (July 12, 2004); Letter from Roosevelt F. Dorn, Mayor, Inglewood, California, to Joe Barton and John Dingell, U.S. House of Representatives (July 12, 2004); Letter from Irene H. Brodie, Mayor, Robbins, Illinois, to Joe Barton and John Dingell, U.S. House of Representatives (July 12, 2004); *see also* Letter from Linda T. Sanchez, U.S. House of Representatives, to Michael K. Powell, Chairman, FCC (June 30, 2004); Letter from Congressman Raul M. Grijalva, U.S. House of Representatives, to Michael K. Powell, Chairman, FCC (July 12, 2004); Letter from Representative Steve Gallardo, Arizona House of Representatives, to Michael K. Powell, Chairman, FCC (July 2, 2004); Letter from Dannel P. Malloy, Mayor, Stamford, Connecticut, to Michael K. Powell, Chairman, FCC (July 6, 2004); Letter from Mayor Douglas Palmer, National Conference of Democratic Mayors, to Marlene H. Dortch, Secretary, FCC (July 8, 2004); Letter from Leroy Comrie, Council Member, City of New York, New York, to Michael K. Powell, Chairman, FCC (July 15, 2004).

would have in comparison to their current service packages in terms of price, quality, and diversity.[10]

### B. Demands For A So-Called "Voluntary" À La Carte System Are Misleading And, In Any Case, Would Be Manifestly Contrary To The Public Interest

While opposition to a mandatory à la carte regime is almost universal, some commenters propose a so-called "voluntary" system, in which MVPDs would have the option of selling program services on an individual basis.[11] The great weight of the evidence in this proceeding, however, flatly refutes the unsupported assertions by these parties that such a system would in any sense serve the interests of consumers.

Most fundamentally, this allegedly "voluntary" system, in fact, would not be voluntary at all for programmers. As proponents of the system acknowledge, the government would be called upon to interfere with existing contracts between programmers and distributors, impose severe restrictions on how networks sell their services, and regulate the details of the prices, terms and conditions of program sales.[12]

The so-called "voluntary" à la carte system also would suffer from the same fundamental problems as mandatory à la carte. In addition to the costs imposed by new regulatory burdens, the cost of marketing programming would increase dramatically, and subscription fees and advertising rates would drop, due to the decline in subscribership. Consequently, consumers

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[10] *See, e.g.*, Andrea Plummer Comments (July 7, 2004); Sallie Jackson-Asghar Comments (July 7, 2004); William R. King Comments (July 15, 2004).

[11] Such a regime, these commenters assert, would provide consumers with more choice, *see* ACA Comments at 6; enable subscribers to avoid paying for services that they find undesirable, *see* Consumers Union and Consumer Federation of America Comments ("CU/CFA Comments"), The America Channel Comments at 1, BSPA Comments at 11, CT Communications Comments at 4; promote the development of new independent programming, *see* BSPA Comments at 12-13, CT Communications Comments at 15-17; and better serve the needs of networks and advertisers, *see* BSPA Comments at 13.

[12] BSPA Comments at 15-16.

would confront higher rates and, perhaps most critically, a decline in the quality and diversity of program offerings.  Even the alleged beneficiaries of à la carte—independent programmers—make abundantly clear that the inability to ensure carriage is the greatest obstacle to launching and sustaining a new service.[13]  In addition, ACA and several other parties voiced opposition to *mandatory* à la carte due to the huge costs MVPDs would incur to install the technology necessary to make per-channel selections possible.[14]  Yet, these same substantial technology costs would be incurred in the implementation of a "voluntary" à la carte regime, and those costs undoubtedly would be passed on to consumers.  In essence, these operators are seeking the right to make their existing obligations to programmers optional, without giving programmers anything in return for this increased flexibility and without any obligation to pass additional options on to consumers.

Moreover, claims that providing an à la carte option would enable consumers to avoid paying for services that they do not want simply are off base.[15]  As Economists Incorporated ("EI") explains in the attached response, consumers pay not for unwanted channels, but for a

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[13] *See infra* Section I(A).  In obvious recognition of this serious impediment to new program development, one *proponent* of à la carte ironically seeks a multi-year "grace period" from à la carte treatment for start-up services, because consumers are so unlikely to subscribe to new networks that are sold on an individual basis.  *See* The America Channel Comments at 1-2.  It is not clear, however, that this proposal would provide even a temporary solution for start-up services.  In an à la carte system, there presumably would be no packages of well-established services with which such newly launched services could be packaged.

[14] *See* ACA Comments at 6-7; *see also* BSPA Comments at 10; EchoStar Comments at 1, 3.  Indeed, ACA notes that its members cannot afford the transition to digital services that would be required in order to offer à la carte services.  ACA Comments at 48-49.  Thus, the voluntary and mixed tiering/à la carte systems proposed by some commenters would risk putting some operators out of business.  *See, e.g.*, EchoStar Comments at 3-4; CU/CFA Comments at 7; Center for Creative Voices in Media Comments at 8; Parents Television Council Comments at 3-4.

[15] *See* CU/CFA Comments at 2-3; BSPA Comments at 11; CT Communications Comments at 4; The America Channel Comments at 1.

complete package of program services.[16] The package as a whole must be worth at least as much to consumers as the price charged for it; otherwise, they would not subscribe. Indeed, program services, like many other products, are bundled into a single package in order to provide low-cost variety to consumers. In particular, when it costs little for a provider to add variety to a product that some people will like, it is in the best interests of both the distributor and consumers to include such elements, even though they may not appeal to everyone. In such circumstances, it is often far more cost-efficient to provide all consumers with a relatively broad bundle of services than to enable consumers to hand pick individual packages.[17]

To illustrate this point, EI analogizes program tiers to the packaging of crayons.[18] Consumers can purchase crayons in boxes of varying sizes, just as they can choose among the different tiers offered by an MVPD. In each box of crayons, there are colors that a particular consumer will use frequently, and other colors that the consumer rarely or never will use. Yet, the colors are sold in packages so that the vast majority of consumers can get the colors they do want at a relatively low cost. While one consumer may not care to use the periwinkle crayon, for example, it inevitably will be someone else's favorite color. By including that color in a box, the distributor makes the box more appealing to consumers as a whole, even though it may add no value for some consumers.

In addition, consumers may value the option of using new colors in the future.[19] Distributing crayons in boxes gives consumers the opportunity to experiment with new colors

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16 *See* Bruce M. Owen and John M. Gale, Economists Incorporated, *Why a Box of Crayons Has Many Colors and the "Cable Tax" Is Not a Tax*, at 4-5 (August 13, 2004) (Attachment 1) ("EI Response").

17 *Id*. at 4.

18 *See id*. at 3-6.

19 *See* EI Response at 5.

and provides ready access to colors that they may use only on an occasional basis or for which they may have an unexpected need. By contrast, it likely would be considerably more expensive and burdensome to provide each consumer with only the colors that he or she wants at any given time. Such a system could entail, for example, the creation and maintenance of a specialized crayon store, where there would be bins of individual crayons and customers could mix and match colors.[20] Of course, consumers would be required to take a special trip to the store in order to buy crayons and to spend the time to select individual color assortments. They also would need to return to the store every time they had a need for a new color. By the same token, the inclusion of a wide range of program networks into a single package makes MVPD service more valuable and less costly to consumers as a whole, even though some subscribers may not value certain channels within the package.

For these same reasons, the assertion by Consumers Union/Consumer Federation of America that an à la carte option would remove the "cable tax" that subscribers currently pay for unwanted program services is fundamentally flawed.[21] In particular, the notion of a "tax" implies that consumers pay more for a bundle of services than they would pay for only the services they want on an à la carte basis.[22] As demonstrated in the initial comments of Viacom and numerous other parties, the opposite is, in fact, far more likely to be true.[23] Moreover, Consumers Union/Consumer Federation of America erroneously assumes that the only channels that consumers "want" are those that they watch on a regular basis.[24] As described previously,

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20 *See id*.

21 *See* CU/CFA Comments at 2-3.

22 *See* EI Response at 6-7.

23 *See* Viacom Comments at 21-25; *see also* Section I(A), *infra*.

24 *See* CU/CFA Comments at 3 (noting that "the average consumer watches about 12-17 channels regularly").

however, subscribers also derive substantial value from the ability to sample new networks and to watch additional services on an occasional basis.[25] In sum, the misleadingly named "voluntary" à la carte proposals should be flatly rejected by both the FCC and Congress as directly contrary to consumer interests.

## II. THERE IS NO BASIS FOR ADDITIONAL REGULATORY INTERFERENCE IN RETRANSMISSION CONSENT NEGOTIATIONS

A small handful of commenters contend that broadcasters consistently engage in anticompetitive tactics in the context of retransmission consent negotiations.[26] In particular, these parties attempt to depict broadcasters' willingness to exchange the carriage of affiliated program services for MVPD retransmission consent rights as a blatant and harmful exercise of market power. In actuality, there is nothing inherently anticompetitive about this form of bundling and, as demonstrated by traditional antitrust analysis as well as FCC precedent, the current negotiations between broadcasters and MVPDs are not conducted in an anticompetitive manner. Thus, the long list of changes that these parties seek to make to the existing retransmission consent and program access regimes are wholly unnecessary. Making the drastic changes recommended by these commenters would, moreover, do violence to the competitive objectives Congress sought to achieve in establishing these regulatory regimes.

### A. MVPDs Historically Have Offered In-Kind Consideration For Broadcast Carriage

The offering of program services in packages to MVPDs is a longstanding industry practice that began at the insistence of cable operators and that balances the competitive interests of programmers and MVPDs. When the first retransmission consent negotiations were

[25] *See* Viacom Comments at 10.

[26] *See* ACA Comments at 3-6, 15; EchoStar Comments at 5-7; CT Communications Comments at 2; Discovery Comments at 26-30; The Pioneer Telephone Association Comments at 5-6 ("Pioneer Telecom Comments").

conducted in the early 1990s, leading cable operators insisted that they would make no cash payments to broadcasters.[27] Eventually, agreements were reached between the broadcast networks and cable operators that provided for the cable operators to carry various new broadcast network-owned cable programming services in return for retransmission consent rights to local TV signals. This arrangement made sense for both parties, as MVPDs were able to obtain broadcast carriage rights at relatively low cost and programmers gained important distribution rights. Since that time, retransmission consent negotiations between broadcasters and MVPDs generally have involved package deals, at the insistence of the MVPD buyers.

Since this practice has become the industry norm, the FCC has endorsed the policies underlying it on several occasions. In establishing guidelines for "good faith negotiations," for example, the Commission deemed "[p]roposals for carriage conditioned on carriage of any other programming, such as . . . an affiliated programming service" as presumptively in good faith and "consistent with competitive marketplace considerations."[28] The agency further noted in this regard that "arbitrarily limit[ing] the range or type of proposals that the parties may raise in the context of retransmission consent will make it more difficult for broadcasters and MVPDs to reach agreement."[29] Similarly, in resolving a retransmission consent dispute between EchoStar and Young Broadcasting in 2001 in Young's favor, the FCC noted that "offering retransmission consent in exchange for … other programming such as a cable channel" is "consistent with competitive marketplace considerations."[30]

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27 *See* Disney Comments at 41, n. 57; *see also id*. at 42, n. 62.

28 *Implementation of the Satellite Home Improvement Act of 1999*; *Retransmission Consent Issues: Good Faith Negotiation and Exclusivity, First Report and Order*, 15 FCC Rcd 5445, 5469-70 (2000).

29 *Id*. at 5469.

30 *EchoStar Satellite Corporation v. Young Broadcasting*, 16 FCC Rcd 15070, 15079 (2001).

As explained below, antitrust analysis shows that there is no basis for altering this longstanding industry practice through regulatory intervention.

### B. Existing Bundling Arrangements Are Consistent With Traditional Antitrust Principles

A few comments submitted in this proceeding, most notably EchoStar's, have suggested that seeking carriage of affiliated cable programming as consideration for retransmission consent rights violates the antitrust laws and, on that basis, have urged the Commission to find that such alleged "tying" arrangements violate the retransmission consent/good faith statutory mandate.[31] As discussed below, these commenters have misunderstood, or perhaps misstated, current antitrust jurisprudence and economic thinking on tying and bundling.

The Supreme Court's decision in *Jefferson Parish Hospital District. No. 2 v. Hyde* is the starting point for analyzing tying and bundling arrangements under the antitrust laws.[32] As Justice O'Connor stated in her oft-cited concurrence in *Jefferson Parish*, "a tie has been illegal only if the seller is shown to have sufficient economic power with respect to the tying product to appreciably restrain free competition in the market for the tied product…."[33] This is because there is nothing inherently anticompetitive about tying or bundling. In fact, "[b]uyers often find

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31 *See* EchoStar Comments at 6-7. This Section II(B) assumes *arguendo* that "bundling" retransmission consent and program carriage constitutes "tying." *See Marts v. Xerox, Inc.*, 77 F.3d 1109, 1113 (8th Cir. 1996) (no unlawful tying where products are separately available; plaintiff failed to show that purchasing products together is the only viable economic option); *Amerinet, Inc. v. Xerox Corp.*, 972 F.2d 1483, 1500-01 (8th Cir. 1992) (no tying arrangement when purchaser can take either product by itself, even if seller also offers the products as a unit at a single price). In comments previously submitted to the Commission, however, Disney, Fox, NBC, and Viacom all noted that: "The reality is that the Broadcast Networks offer Cox and other cable operators multiple options for consideration in exchange for retransmission consent, most often a cash payment per subscriber or carriage of affiliated cable programming channels. Whether Cox or any cable operator carries affiliated programming channels or pays cash is the result of its choices made in marketplace negotiations." Reply Comments of Fox Entertainment Group, Inc. and Fox Television Stations, Inc.; National Broadcasting Company, Inc. and Telemundo Communications Group, Inc.; Viacom; and The Walt Disney Company and the ABC Television Network, *Annual Assessment of Competition in the Delivery of Video Programming*, MB Docket No. 03-172, at 2 (Sept. 26, 2003).

32 466 U.S. 2 (1984).

33 *Id*. at 34 (internal citation omitted).

package sales attractive; a seller's decision to offer such packages can merely be an attempt to compete effectively—conduct that is entirely consistent with the Sherman Act."[34] Just this term, the Supreme Court warned the lower courts to be mindful of "false positives" (*i.e.*, mistaken condemnation of procompetitive conduct) in applying the antitrust laws.[35] Specifically, the Court admonished that "[m]istaken inferences and the resulting false condemnations are especially costly, because they chill the very [types of competitive] conduct the antitrust laws are designed to protect."[36] Here, a "false positive" would arise from any presumption that linkage between retransmission consent rights and carriage of affiliated cable programming is anticompetitive.

Relying on *Jefferson Parish*, lower courts now generally require antitrust plaintiffs to prove, *inter alia*, the following elements to state an unlawful tying claim: (1) sufficient economic power in the tying product market to coerce the purchase of the tied product; (2) evidence of actual coercion; and (3) an appreciable effect on competition in the tied market.[37] Under these criteria, an antitrust plaintiff could not establish that the mere linking of retransmission consent with carriage of affiliated cable networks—or the packaging of cable networks—demonstrates an illegal tying arrangement.

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34 *Id.* at 12.

35 *Verizon Comm. Inc. v. Law Offices of Curtis V. Trinko*, 124 S. Ct. 872, 882 (2004).

36 *Id.* (*citing Matsushita Elec. Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574, 594 (1986)) (internal quotations omitted).

37 *See, e.g., Hack v. President and Fellows of Yale Coll.*, 237 F.3d 81, 86 (2d Cir. 2000). In addition, of course, courts must find the existence of a tying and a tied product. *See supra* note 31.

### 1. Absence of Coercive Power

At least in the absence of MVPD/programmer vertical integration, an individual broadcast network does not have "*sufficient* economic power in the tying market to *coerce* purchaser acceptance of the tied product."[38] Contrary to EchoStar's suggestion, therefore, it is not sufficient for a plaintiff to demonstrate that a network owned station merely possesses *some* degree of market power. It must show that such power is sufficient to coerce acceptance of the tied product. A reviewing court almost certainly would reject any claim that a single network station has coercive market power. This is especially the case in today's robust programming marketplace, which consists not only of broadcast and traditional MVPD services, but also an ever-expanding range of new choices.[39]

In particular, "[c]ourts have consistently refused to consider one brand to be a relevant market of its own when the brand competes with other potential substitutes."[40] Thus, it is preposterous to contend that the broadcast networks don't compete with each other—much like arguing that Coke and Pepsi don't compete as they struggle to achieve the best possible supermarket "shelf space" (and other desirable terms) for the lead product and each of its various subsidiary brands. Indeed, it is likely that an antitrust court would view broadcast networks as

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[38] *Hack v. Yale*, 237 F.3d.at 86 (emphasis added).

[39] In recent decisions, the FCC has observed the increasing competitive pressure that subscription video services have placed on the broadcast networks. *See, e.g.*, *2002 Biennial Regulatory Review—Review of the Commission's Broadcast Ownership Rules and Other Rules Adopted Pursuant to Section 202 of the Telecommunications Act of 1996, Report and Order and Notice of Proposed Rulemaking*, 18 FCC Rcd 13620, 13665-66 (2003) (noting that "[s]ince its inception, non-broadcast programming has gained significantly in popularity as compared with broadcast programming" and that "broadcasters face intense competitive pressure from alternative video programming") ("*2002 Biennial Review Order*").

[40] *Hack v. Yale*, 237 F.3d at 86 (*quoting Little Caesar Enterprises, Inc. v. Smith*, 34 F.Supp.2d 459, 477 n. 30 (E.D. Mich. 1998)); *see also Town Sound and Custom Tops, Inc. v. Chrysler Motors Corp.*, 959 F.2d 468, 480 (3d Cir. 1992) ("Except in rare circumstances, courts reject market definitions consisting of one supplier's products where other brands compete.").

part of a larger market that includes all cable channels, at least those channels that are advertiser-supported.

Moreover, EchoStar's reliance on the FCC's recent *News Corp./DIRECTV* decision as support for its broad-based antitrust arguments is inapposite.[41] Significantly, in that case, the agency did not find that a non-vertically integrated network station owner possessed the power to coerce carriage. Indeed, it found that the relative bargaining positions of broadcasters and MVPDs generally were in equipoise:

> Both programmer and MVPD benefit when carriage is arranged: the station benefits from carriage because its programming and advertising will likely reach more households when carried by MVPDs than otherwise, and the MVPDs benefit because the station's programming adds to the attraction of the MVPD subscription to consumers. Thus, the local television broadcaster and the MVPD negotiate in the context of a roughly even 'balance of terror' in which the failure to resolve local broadcast carriage disputes through the retransmission consent process potentially *damages each side greatly* in their core business endeavor.[42]

Rather than finding that there was any existing imbalance in the retransmission consent negotiations, the *News Corp./DIRECTV* decision focused on the shift in bargaining power that could result from the proposed vertical integration of an MVPD and a broadcaster.[43] Chairman Powell underscored in his separate statement that the Commission's action was based solely on

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[41] *General Motors Corporation and Hughes Electronics Corporation, Transferors And The News Corporation Limited, Transferee, For Authority to Transfer Control, Memorandum Opinion and Order*, 19 FCC Rcd 473, 555-57 (2004) ("*News Corp./DIRECTV*").

[42] *Id.* at 556 (emphasis added).

[43] *See id.* at 568 (concluding that "the transaction will increase News Corp.'s post-transaction incentive and ability to temporarily withhold access to the signals of its television broadcast stations as a negotiating tactic by lowering the risks of and costs to News Corp. of engaging in such foreclosure"); *see also* EI Response at 10-14. Accordingly, the agency's decision to take remedial action was necessitated only when "News Corp.'s acquisition of DIRECTV" threatened to substantially disrupt this balance. *Id.* at 565.

"merger-specific harm[s]" relating to the transaction at issue.[44] Thus, in the absence of such vertical integration, it is abundantly clear that individual networks lack the requisite level of economic power to coerce MVPDs.

This conclusion is consistent with the outcome one would expect in a straightforward antitrust analysis of these facts and circumstances. Under any reasonable approach to market definition, none of the broadcast networks would be deemed to have a market share in excess of 30 percent. And since *Jefferson Parish*, "no court has inferred the requisite market power [to state a tying claim] from a market share below 30 percent."[45]

2. Absence of Actual Coercion

In light of the "roughly even 'balance of terror'" that characterizes the positions of MVPDs and programmers, it is evident that neither side has coercive power over the other. Given the absence of such power, it is an *a fortiori* proposition that neither party is in a position to demonstrate the *actual exercise* of coercive power by the other.

But this is not merely a theoretical proposition. Its validity is borne out in the results of real world, head-to-head negotiations. Last year's well-publicized contract negotiations between EchoStar and Viacom provide an excellent illustration that the current system works. In those negotiations, Viacom sought to have EchoStar carry more programming services and give those services broader distribution, while EchoStar negotiated to carry fewer channels and place them on different tiers. In the end, EchoStar's CEO acknowledged that his company had successfully

[44] *News Corp./DIRECTV* (Separate Statement of Chairman Michael K. Powell, at n. 2).

[45] ABA Section of Antitrust Law, *Antitrust Law Developments*, at 196 and cases cited therein at n. 1111 (5th ed. 2002).

negotiated a deal that was "good enough" for both parties[46]—demonstrating, once again, that these private contract disputes involve parties who are quite clearly capable of looking out for their own interests without governmental intervention, and that the "balance of terror" leads to just the kind of open market resolution that tough bargaining and tough competition encourages.[47]

More generally, Viacom simply does not "force" MVPDs to carry any of its program services. Despite the handful of claims to the contrary,[48] all MVPDs are, in fact, free to buy none, one, several, or all of Viacom's services. As demonstrated by the EI study submitted with Viacom's opening comments, for example, *no* cable system offers *all* of Viacom's program services, and only 13 percent of the systems studied took 75 percent or more.[49] In addition, more than one-quarter of cable systems currently carry some, but not all, of MTV Networks' traditional analog services. When the top six cable operators are excluded from the pool, moreover, that number nearly doubles. Thus, about half of the country's smaller operators decline to take all of the MTV Networks basic analog services. Of these systems, six percent have chosen to buy Nickelodeon and *not* MTV, while seven percent have chosen to buy

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46 *See, e.g.*, John M. Higgins, *The Blackout Backfired*, Broadcasting & Cable (March 15, 2004); *see also* EchoStar Communications, Call to Discuss Viacom Agreement at 5-6 (March 11, 2004), available at www.callstreet.com/call_schedule.asp?eventid=21816.

47 This balance is a factor not just in broadcasters' carriage negotiations with the largest multi-system operators, but also in their dealings with smaller MVPDs. It is critical for Viacom and other broadcasters to have their services viewed by as broad an audience as possible, and overall, small operators provide service to a substantial portion of U.S. viewers. Furthermore, many small MVPDs operate in rural areas where over-the-air reception is unavailable and MVPD services provide the only means to view both broadcast and subscription programming. In such areas, achieving MVPD carriage takes on even greater importance.

48 *See* ACA Comments at 3; EchoStar Comments at 3; CT Communications Comments at 2.

49 *See* Viacom Comments at 10-11; *see also id.*, Attachment 1 (Bruce M. Owen and John M. Gale, Economists Incorporated, *Cable Networks: Bundling, Unbundling, and the Costs of Intervention*, at 16-19).

Nickelodeon and *not* SPIKE TV. Thus, real-world evidence flatly contradicts claims that cable operators and other MVPDs are given no legitimate choice but to carry all Viacom services.

3. Absence of Anticompetitive Effects

In addition, it is unlikely that a court would find that linking retransmission consent rights to carriage of affiliated cable programming would have an appreciable effect on competition in a putative tied market (*i.e.*, cable programming). Indeed, in light of the abundance of channels MVPDs are now able to offer their subscribers, retransmission consent negotiations that result in the carriage of one or more affiliated program services simply cannot have a significant impact on today's incredibly robust and highly competitive program marketplace.[50] In sum, bundling retransmission consent with the carriage of cable program services is consistent with competitive marketplace considerations and should continue, as explained next, without further regulatory intervention.

### C. The Specific Requests For Intervention In Retransmission Consent Negotiations Are Wholly Unnecessary And Would Undermine Important And Longstanding Congressional Objectives

The handful of commenters who have expressed grievances with the retransmission consent process have requested a laundry list of changes to the congressionally mandated retransmission consent scheme, which would impose onerous burdens on over-the-air broadcasters.[51] As discussed above, these changes are not needed to correct any competitive imbalance. Moreover, these efforts to restrict or eliminate local broadcasters' retransmission consent rights would eviscerate the competitive objectives that Congress and the Commission sought to achieve in establishing and implementing the retransmission consent regime. In

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50 *See, e.g., 2002 Biennial Review Order*, 18 FCC Rcd at 13634 (noting that consumers are now "served by literally hundreds of networks serving all conceivable interests"); *see also* Viacom Comments at 6-8.

51 *See* ACA Comments at 16-17; EchoStar Comments at 4-7; CT Communications Comments at 11.

particular, such regulatory intervention would threaten the congressional goal of ensuring the continued viability of free, over-the-air broadcasting.

Aside from alarmist rhetoric, these commenters provide no basis for the Commission to recommend such far-reaching regulatory measures. The speculative allegations made by these parties are devoid of specific examples, and they provide no economic analysis in support of their claims. Moreover, to the extent that an MVPD may believe that an individual broadcaster has acted in bad faith in the context of retransmission consent negotiations, there already is a comprehensive complaint process in place at the FCC to resolve such concerns and to provide the aggrieved distributor with a remedy.[52] No commenter to this proceeding has suggested that this complaint process is in any way insufficient to deal with specific instances of bad faith negotiations.[53]

In essence, these few commenters seek to deprive broadcasters of the right to be fairly compensated for the carriage of their local signals and, thereby, to regress to the unbalanced environment that existed prior to the enactment of the retransmission consent statute. For decades, the Communications Act granted broadcasters no right to control the use of their signals by MVPDs, which were free to carry local broadcast signals without "having to compensate the broadcaster for the value its product create[d]" for them.[54] By 1992, however, Congress realized

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[52] *See* 47 C.F.R. § 76.7.

[53] Several parties to this proceeding ask the FCC to require programmers to disclose the prices, terms, and conditions of their carriage agreements. *See* ACA Comments at 8-9; CT Communications Comments at 2, 9; Public Cable Television Authority Comments at 1-2 (July 12, 2004). As EI explains, such a requirement is both unnecessary and actually could reduce competition. *See* EI Response at 7-8. Non-disclosure contract provisions are commonplace in the U.S. economy. Moreover, in some circumstances, revealing information about wholesale prices to competitors has been viewed as anticompetitive and conducive to the formation or stability of cartels. In the context of carriage negotiations, MVPDs benefit substantially from the fact that programmers do not know the amount that operators have paid for competing networks.

[54] S. Rep. No. 102-92, at 35 (1991), reprinted in 1992 U.S.C.C.A.N. 1133, 1168. While the Communications Act precluded a broadcast station from "rebroadcast[ing] the program or any part thereof of another broadcasting

that this inability of broadcasters to control the use of their signals created a "distortion in the marketplace which threaten[ed] the future of over-the-air broadcasting."[55] Congress specifically recognized that "a very substantial portion of the fees which consumers pay to cable systems is attributable to the value they receive from watching broadcast signals" and that the law should not endorse a system "under which broadcasters in effect subsidize the establishment of their chief competitors."[56]

To address this marketplace distortion, Congress enacted an overall regime establishing and defining the circumstances under which cable operators could obtain the right to retransmit broadcast signals.[57] Under this "retransmission consent" regime, MVPDs must obtain "express authority" from a station before retransmitting its signal, and broadcasters have the ability to seek just compensation in exchange for such carriage rights.[58] In passing this legislation, Congress was careful to note that its "intention [was] to establish a marketplace for the disposition of the rights to retransmit broadcast signals," and not "to dictate the outcome of the ensuing marketplace negotiations."[59] Moreover, Congress specifically anticipated that the

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station without the express authority of the originating station," 47 U.S.C. § 325(a), the FCC concluded this statutory prohibition did not extend to cable operators. *CATV and TV Repeater Services*, Report and Order, 26 F.C.C. 403 (1959).

55 S. Rep. No. 102-92, at 35, 1992 U.S.C.C.A.N. at 1168.

56 *Id*.

57 Congress expected that broadcasters would utilize this newly created right to obtain compensation (*e.g.*, cash or the carriage of other program services) in exchange for grants of retransmission consent and therefore would be better able to compete in the video marketplace. *Id*. at 35-36, 1992 U.S.C.C.A.N. at 1168-69.

58 47 U.S.C. § 325(a).

59 S. Rep. No. 102-92, at 36, 1992 U.S.C.C.A.N. at 1169.

consideration paid by a cable operator in exchange for carriage of a local signal could be "the right to program an additional channel on a cable system."[60]

In addition to their requests to essentially do away with the retransmission consent rules, several parties ask the FCC to further weaken broadcasters' rights to negotiate for carriage of their local signals by reciting their typical requests to expand the program access rules to non-vertically integrated programmers, including broadcasters.[61] Like the retransmission consent laws, the program access rules enacted by Congress in 1992 were targeted at a specific marketplace imbalance—the ability of cable operators and programmers *vertically integrated* with cable operators to impede the development of nonaffiliated cable operators and competitive MVPDs.[62] In creating the program access protections, Congress specifically observed that "vertically integrated program suppliers have the incentive and ability to favor their affiliated cable operators over other multichannel programming distributors."[63] Although parties repeatedly have asked the agency to expand the scope of the program access rules to non-vertically integrated programmers, the Commission consistently has rejected such requests as

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60 *Id.* In addition, in 1999, Congress granted DBS operators a copyright license to make secondary transmissions of a broadcast station's signal into the station's local market through the adoption of the Satellite Home Viewer Improvement Act of 1999. Pub. L. No. 106-113, 113 Stat. 1501, Appendix I (1999).

61 S*ee* ACA Comments at 18-19; CT Communications Comments at 11; EchoStar Comments at 7-8.

62 *Implementation of the Cable Television and Consumer Protection and Competition Act of 1992*, 17 FCC Rcd 12124, 12158 (2002).

63 *Implementation of Sections 12 and 19 of the Cable Television Consumer Protection and Competition Act of 1992,* 8 FCC Rcd 3359, 3366 (1993). Moreover, while the program access provisions prohibit vertically integrated satellite program providers from engaging in various forms of price discrimination, Congress specifically permitted these cable-affiliated entities to offer MVPDs "different prices, terms, and conditions that take into account economies of scale, cost savings, or other direct and legitimate economic benefits reasonably attributable to the number of subscribers served by the distributor." 47 U.S.C. § 548(c)(2)(B)(iii); *see also Implementation of Sections 12 and 19 of the Cable Television Consumer Protection and Competition Act of 1992*, 8 FCC Rcd at 3407. The calls by some commenters to eliminate the right of programmers to offer such volume discounts are unsupported by economic analysis and ignore the fact that such discounts are commonplace in economic transactions. *See* Pioneer Telecom Comments at 8-9; National Telecommunications Cooperative Association Comments at 4-5.

contrary to both the language of the statute and, more importantly, to Congress' intent to "limit[] the program access provisions to a specific group of market participants."[64] No party to this proceeding provides any basis for the FCC to abandon its consistent position on this issue.

In sum, by calling for broadcasters' retransmission consent rights to be dismantled, these commenters are transparently seeking to do little more than advance their individual bargaining power by denying broadcasters the rights that they would have in a competitive atmosphere to seek fair compensation for their services. In so doing, these parties would upset the careful balance struck by Congress in establishing both the retransmission consent and program access regimes. In particular, they would undo the measures that Congress took to ensure the continued viability of free, over-the-air broadcasting in today's increasingly subscription-oriented video programming environment. No changes have occurred since these laws were passed to warrant such a far-reaching shift in Congress' and the FCC's public interest objectives.

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[64] *Implementation of the Cable Television and Consumer Protection and Competition Act of 1992*, 17 FCC Rcd at 12158.

## III. CONCLUSION

Viacom submits that the FCC should report to Congress that a mandatory à la carte or themed tiering regime would be harmful to both industry participants and consumers. The FCC further should clarify that imposing increased regulatory burdens on the retransmission consent process would be unnecessarily onerous and, thus, detrimental to the public interest.

Respectfully submitted,

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August 13, 2004

# ATTACHMENT 1

# Why A Box of Crayons Has Many Colors, and the "Cable Tax" is not a tax

# Why Contract Confidentiality Promotes Competition

# and

# Why the *News Corp* Retransmission Consent Conditions Don't Apply to Other Broadcast Networks

**by**


**Bruce M. Owen and John M. Gale**


**August 13, 2004**


***Economists Incorporated***

**Washington DC**

# Why A Box Of Crayons Has Many Colors, And The "Cable Tax" Is Not A Tax

## Why Contract Confidentiality Promotes Competition

## And

## Why The News Corp Retransmission Consent Conditions Don't Apply To Other Broadcast Networks

**by**

**Bruce M. Owen and John M. Gale**[†]

### Summary

Viacom asked us to provide economic analysis of certain issues raised by first round filings in this proceeding. In this brief paper, we reiterate our point that bundling is, in general, a practice highly beneficial to consumers and to competition. We also point out that economic theory does not, as has been insinuated, condemn as inherently suspect all instances of product bundling. Further, the argument that MVPD subscribers are being "taxed" for programming they "do not want" makes no economic sense.

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We also examine two issues raised by the American Cable Association. First, we demonstrate that the forcible public disclosure of confidential terms of contracts between program suppliers and MVPDs could readily have the effect of reducing competition. Second, we point out that the Commission's conditions regarding retransmission consent negotiations placed on News Corp. when it acquired DirecTV were related to the economic structure of that specific transaction; they make no sense applied to other, non-vertically-integrated, broadcast networks.

**Why A Box of Crayons Has Many Colors**

It simply cannot be true, as a matter of common sense, that there is a grave economic inefficiency associated with every product that we purchase, owing to its being made up of various parts. As we pointed out in our earlier paper in this proceeding, virtually all goods and services are bundled at the time of sale. [1] Very often, perhaps most often, the parts of the bundle are not available separately, or would cost more than the price of the bundle if supplied separately.

Nevertheless, some commentators in this proceeding on à la carte cable pricing have asked, "Why should I have to pay for channels I never watch?" The short answer is that they are not paying for them, they are paying for a complete package. The package as a whole is worth more than the price; otherwise they would not subscribe. The long answer requires explaining some basic economic concepts about how bundling a variety of elements into a single sale benefits both the seller and the buyer.

Many products are bundled because the bundling service itself is highly valuable to consumers, as with the purchase of an automobile. Many other products are bundled together into a single sale in order to provide variety to buyers at low cost. For this type of product, consumers would like to have a variety of different types of the product offered as a single purchase. An analogy, though not an exact one, can be drawn between cable networks and crayons. Consumers can choose among 8, 16, 64, or (the coveted) 96 crayon boxes, just as they can choose among the various tiers offered by an MVPD. In each of the boxes there are col-

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[1] Bruce Owen and John Gale, *Cable Networks: Bundling, Unbundling, and the Costs of Intervention*, July 15, 2004, submitted with Viacom's initial comments in the matter of À La Carte and Themed Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems, FCC Docket No. MB-04-207 (July 15, 2004).

ors that a particular consumer likes and uses often and colors that he will likely never use. One could ask the same question about crayons as about cable networks: "Why should I be forced to pay for crayons that I don't like and will never use?" Why shouldn't regulators require that crayons be unbundled so that consumers can buy only the colors they like?

The answer is the same for both crayons and cable networks, though the intuition behind it may be clearer for crayons. For products where it costs little (or nothing) for a provider to include more variety that *someone* may like, it is in the best interests of the seller and the buyer to include elements that not *everyone* wants. One consumer may not care to use the periwinkle crayon, but that is someone else's favorite color, so it is included in the box to please the second person and get him to buy a box. A maker of crayons knows that some colors are popular and some are not-so-popular. To make as many sales as he can, the crayon maker will include the popular colors in more boxes and will also include the not-so-popular colors in some boxes to induce the odd-color-lovers to buy a box of crayons. A color may be included only in the largest box if it appeals to few people, even though it is especially important to those people. In this way the seller makes the complete box more valuable to consumers as a whole, even though it may not make it more valuable to a particular consumer. Finally, it has to be the case that each buyer values the box of crayons he chooses to buy more than the price he pays, even though he may not value a particular color at all. Similarly, removing a particular color from the box because a buyer does not intend to use it would not change the price charged for the box of crayons. The same price is charged to all buyers, whether they use only one color or every color in the box.

In the same way, an MVPD will offer the most popular channels in most packages (or tiers) while also including some specialty or niche channels. By including more channels, the entire package is more valuable to potential cable subscribers on average, so the cable system sells more subscriptions. At the same time, a particular subscriber may not find that the additional channels make the package more valuable to her. It is always true that each subscriber values the entire package more than the price she pays *or she would not choose to subscribe.*

It may seem wasteful for a seller to give people crayons (or channels) that they do not use, but in fact, it can be more costly to provide only the specific colors each buyer wants. For crayons, one could imagine a specialized crayon store with bins of each color crayon where a buyer could mix and match whatever colors he wants. Of course, this would require the creation of the specialized crayon store and a trip by each consumer to the store. In the case of MVPDs, this would require each consumer to have a set-top box for each television and to have good information about the programming on every network offered by the cable system. It is likely more efficient to give a buyer some crayons he does not use (or a subscriber channels she does not watch) than to mandate a system where each buyer only gets the colors he likes (or the channels she watches).

An additional feature shared by crayons and MVPD services is that although consumers buy crayons and channels that they never use, they may value the option of using that color or channel in the future. Crayon purchasers often do not know which colors will be right for some future project, and value the option to experiment. Even the consumer who does not like periwinkle and would not buy a periwinkle crayon if it were sold separately, may have an occasion in the future where he has to use periwinkle to make a picture. Even though that event may be unlikely, he still values the option of using the color. Similarly, there are channels included in a cable subscription that a consumer has never watched, but there may be a day when that channel carries a show she wants to see. Because of this, even if she never watches a channel it can still be of some value to her. Of course, it is even easier to see that consumers value crayons or networks that they do use, albeit infrequently, even if they would not choose that crayon or network if sold separately.

A final feature shared by crayons and MVPD service is that consumers may not be able to predict accurately what colors or channels they will like when they make their initial purchase. A consumer may not have a good idea of whether he will use a cyan crayon (in fact, he may not even know what cyan looks like), so he cannot make an informed decision about whether to buy a cyan crayon. After using his box of crayons, he realizes that he loves cyan and uses it all the time, which makes his box of crayons more valuable than he had expected. If cyan had not been included in his box, he would never have known how much he liked it. Similarly, every subscriber's cable package includes channels she would probably not have chosen. But the history of cable television programming is replete with examples of shows carried on obscure cable channels that become very popular. In these instances there have to be consumers who would not have chosen the channel but, after sampling a particular show, are very happy to have the channel in their package.

While it is true that bundling benefits consumers overall, admittedly it can make some consumers worse off. To return to the example, if a consumer wants a blue crayon, and only a blue crayon—and will never use any color but blue—then depending on the cost of providing that choice it can be cheaper for that one consumer if crayons are not bundled. That consumer would be able to buy a box with only a blue crayon, while consumers who prefer a variety of colors would have to select and pay for each individual color. While a consumer with very narrow tastes may be worse off, bundling makes consumers with broad tastes better off because they pay a lower price than if they had to select and purchase each crayon or network individually. As shown in our initial comments, consumers are likely to pay more for the programming they receive if channels were unbundled. Hence, consumers as a whole would be worse off if bundling were prohibited.

On a closely related point, Consumers Union and Consumer Federation of America (CU/CFA) have introduced a new and highly misleading term into the discussion. They maintain that cable subscribers pay a "cable tax."[2] This tax allegedly consists of the payment that consumers make for programming they don't want but which they must purchase in order to get the programming they do want. This term is misleading for at least two reasons.

First, CU/CFA seem to include among the channels that consumers "want" only the channels that they watch "regularly," estimated to be 12-17 channels on average. As we pointed out in our initial comments, consumers who subscribe to a large tier of channels also derive benefits from the channels that they do not view regularly. These consumers are able to tune to channels outside their "regular" channels to watch attractive shows on an occasional basis. They are also able to browse the other channels to determine at low cost whether they would be of interest. Actual behavior shows that consumers value these options and take advantage of them.

Second, the notion of a "tax" implies that consumers pay more for the bundle of programs that includes some channels that are not of interest than they would pay to receive the channels of interest on an à la carte basis. Our initial comments showed that if networks were widely distributed on an à la carte basis, consumers buying a significant number of networks, such as ten, could well end up paying more for those channels than they currently pay for a tier that includes a much larger collection of networks. It is a strange tax that leaves people better off if they pay it than if they don't.

CU/CFA also submitted a paper by sociologist Dr. Mark Cooper, noting that "the possibility of anti-consumer bundling has long been recognized in static consumer welfare economics literature."[3] Dr. Cooper cites three economic articles

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2 *Comments of Consumers Union and Consumer Federation of America*, July 15, 2004, at 3.

3 Mark Cooper, *Time to Give Consumers Real Cable Choices*, July 2004, at 5.

in support of this statement.[4] These papers consider bundling in circumstances that eliminate many of the potential advantages of bundling from being considered. For example, they assume that bundling is strictly a pricing practice, and that consumers derive no utility from the assembly of the bundle on their behalf. They assume that bundles do not cost less to produce and market than their components would. They also assume that each component of the bundle could viably exist as a stand-alone "product;" that is, they do not consider the vast class of components that are efficiently supplied only as "parts." Dr. Cooper is correct that there is the *possibility* of adverse effects from bundling under certain assumptions, but he does not show, and there is no reason to believe, that MVPD bundling satisfies these assumptions. If Dr. Cooper believes that the situations studied in the theoretical papers he cites are applicable to network programming supplied by MVPDs, he must make that case with appropriate evidence. It is absurd to suggest that every bundled product is guilty of causing consumer harm until proven innocent.

**Disclosure of Contract Terms**

The American Cable Association (ACA) argues that the Commission should encourage or require programmers such as Viacom to waive non-disclosure provisions in their contracts with MVPDs, so as to make public the information in those contracts.[5]

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[4] William J. Adams and Janet L. Yellen, "Commodity Bundling and the Burden of Monopoly," *Quarterly Journal of Economics*, (1976), 475-98; Richard Schmalensee, "Gaussian Demand and Commodity Bundling," *Journal of Business*, (1984), 211-30; and R. P. McAfee, John McMillan, and Michael D. Whinston, "Multi-product monopoly, commodity bundling, and correlation of values," *Quarterly Journal of Economics*, (1989), 371-83.

[5] American Cable Association, *Comments*, July 12, 2004, at 8.

Non-disclosure provisions in contracts are commonplace throughout the U.S. economy. Wholesale contracts with major retailers such as Wal-Mart and Toys "R" Us, for example, are not public knowledge, even though these companies are reported to negotiate very favorable terms. Distributors of carbonated beverages have different deals with supermarkets, liquor stores, convenience stores, drug stores, and other businesses, at different prices, but these contracts are not public. ACA's cable operator members probably negotiate rates with advertisers who buy time from them but do not disclose to one advertiser what another advertiser pays.

Making information about prices available to competitors, in some circumstances, has been seen as anticompetitive. For example, price verification calls made by corrugated container suppliers were part of a pattern that the Supreme Court held to be per se unlawful.[6] Such public dissemination is generally seen as conducive to the formation or stability of cartels. In negotiation with a network, it is a benefit to cable operators that the network does not know exactly what fees the operator has agreed to with competing networks. Requiring filing and public disclosure of prices is of course commonplace in regulated industries where the principal purpose of the regulatory authority is to stifle competition. The ICC, before it was abolished, made secret rebates or discounts from public tariffs unlawful, in order to keep motor carrier rates high. Obviously, this did not benefit shippers. The same system applied to railroads, airlines, and other industries. Most observers believe that consumers gained considerably from the deregulation of these industries.

6 *United States v. Container Corp.* 393 U.S. 333 (1968). For a general discussion of information exchanges and their effects on competition, see Dennis W. Carlton and Jeffrey M. Perloff, *Modern Industrial Organization*, 3rd Edition, Chapter 5.

**Retransmission Consent**

ACA also noted that the Commission recently placed restrictions on the way News Corp. could negotiate retransmission consent agreements, as a condition of its approval of News Corp's acquisition of DirecTV.[7] ACA's comments give the impression that the same factors relevant in that matter apply generally to all networks negotiating the sale of retransmission rights and that the additional restrictions placed on News Corp. should be extended to all retransmission consent negotiations.[8]

That impression is not correct, for good economic reasons. The conditions in the News Corp. case were specific to that case, which involved vertical integration between News Corp. and an MVPD (DirecTV). None of the other three major broadcast network owners, Viacom, Disney and General Electric, is vertically integrated with an MVPD. Therefore, the Commission's concern that vertical integration with an MVPD would allow News Corp. to use retransmission consent to harm competition and consumers does not apply to the other major broadcast networks.

When a broadcast television station opts for retransmission consent instead of must-carry, it bargains with MVPDs for compensation in exchange for the right to retransmit its broadcast signal. The FCC has previously pointed out that the conflicting goals of broadcast station owners and MVPDs in retransmission consent negotiations leads to a "balance of terror." Both sides are offering something valuable: the broadcaster is offering content that makes the MVPD's

7 *In the Matter of General Motors Corporation and Hughes Electronic Corporation, Transferors and The News Corporation Limited, Transferee, For Authority to Transfer Control*, MB Docket No. 03-124, Memorandum and Order (released January 14, 2004) ("*News Corp. Order*").

8 American Cable Association, *Comments*, July 12, 2004, at 16-18, 30-31.

product more attractive to subscribers and the MVPD is offering carriage that allows the broadcaster to reach more viewers. Each negotiates to keep as much as possible of the excess value for itself. This negotiation results in a price that balances the costs and benefits to the broadcaster and the MVPD. The Commission put it as follows:

> Although the bargaining may encompass many issues, it is ultimately about the 'price' an MVPD is willing to pay for carriage of the local broadcast station, and although that price may be in the form of monetary compensation, it is more likely to be structured in the form of an 'in kind' payment whereby the MVPD provides channel capacity for a broadcast network's affiliated cable programming network and/or other carriage-related concessions. … Both programmer and MVPD benefit when carriage is arranged: the station benefits from carriage because its programming and advertising will likely reach more households when carried by MVPDs than otherwise, and the MVPDs benefit because the station's programming adds to the attraction of the MVPD subscription to consumers. Thus, the local television broadcaster and the MVPD negotiate in the context of a roughly even "balance of terror" in which the failure to resolve local broadcast carriage disputes through the retransmission consent process potentially damages each side greatly in their core business endeavor. (*News Corp. Order* ¶ 180, footnotes omitted)

The "balance of terror" may be altered, however, if some costs or benefits can be realized in other ways, as, for example, when one side of the negotiation is vertically integrated with a competitor of the other side. In theory, a broadcast station owner that is integrated with an MVPD that competes for subscribers with the negotiating MVPD would take into account any competitive benefits to its own MVPD if the negotiations were to break down. Some economic models show that a downstream firm (MVPD) may be able to exploit vertical integration with an upstream firm (programming supplier or broadcast network) and deny upstream supply to downstream rivals, depending on circumstances.[9] By denying or raising the price of programming, the integrated MVPD may be able to reduce the effectiveness of the competition it faces. In contrast, a non-integrated broadcaster can only benefit from withholding retransmission consent if it subsequently receives a higher price for its content. The interim lack of valuable programming may harm the MVPD, but it also deprives the station of fees or other benefits and provides no benefit to the non-integrated broadcaster.

The portion of the *News Corp. Order* dealing with retransmission consent focused on the problems that might be created if the Fox Owned and Operated broadcast stations were vertically integrated with DirecTV, not with retransmission consent problems in general. For example, during the Commission's investigation leading up to the *News Corp. Order*, some MVPDs contended "the transaction fundamentally shifts the balance of power between MVPDs and Fox broadcast stations in retransmission negotiations because Fox will have the option to walk away from retransmission consent negotiations and broadcast only on DirecTV." (*News Corp. Order* ¶ 184)

In its comments in the News Corp. proceeding, the American Cable Association contended that threats to deny carriage "will particularly disadvantage

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9 See Janusz Ordover, Garth Saloner, and Steven Salop, "Equilibrium Vertical Foreclosure," *American Economic Review*, March 1990, 80(1), pages 127-142; Oliver Hart and Jean Tirole, "Vertical Integration and Market Foreclosure," *Brookings Papers: Microeconomics*, 1990, pages 205-286; Michael A. Salinger, "Vertical Mergers and Market Foreclosure," *Quarterly Journal of Economics*, May 1988, 103(2), pages 345-56; and Christopher M. Snyder, "Empirical Studies of Vertical Foreclosure," in Bob Hawkins, editor, *1995 Industry Economics Conference Papers and Proceedings* Report 95/23 (Canberra: Australian Government Publishing Service, 1995), pages 98-125 and page 107.

DirecTV's smaller competitors in less dense areas of the country once News Corp. acquires control of DirecTV." (*News Corp. Order* ¶ 186) Various parties argued that the Commission's rule that broadcasters negotiate in good faith was an inadequate safeguard in the context of the proposed transaction since "at the time the good faith provisions were adopted, cross-ownership of a cable system and a television broadcast station in the same market was prohibited, so the Commission was unlikely to have considered the impact of common ownership of broadcast stations and an MVPD on retransmission consent negotiations." (*News Corp. Order* ¶ 188, footnote omitted)

Further, the focus of the News Corp. investigation was not on any existing imbalance in the negotiation for retransmission rights, but on a possible *change* in the balance. The Commission focused on whether the proposed transaction *increased* News Corp.'s incentive and ability to withhold the signals of its owned and operated broadcast stations by lowering the costs to News Corp. of employing such bargaining tactics. "Key to determining the degree to which the transaction lowers News Corp.'s costs of engaging in temporary foreclosure is the number of subscribers that can be predicted to shift from the affected MVPD to competitor DirecTV to access the foreclosed programming, which in turn will increase the profits of the post-transaction company as a whole." (*News Corp. Order* ¶ 204) The Commission determined "that the subscriber shifts required for temporary foreclosure to be profitable are likely to be realized." (*News Corp. Order* ¶ 206, footnote omitted)

The Commission concluded "that the transaction will *increase* News Corp.'s post-transaction incentive and ability to temporarily withhold access to the signals of its television broadcast stations as a negotiating tactic by lowering the risks and costs to News Corp. of engaging in such foreclosure. … [T]his *enhanced* incentive and ability to engage in temporary foreclosure will allow News Corp. to extract more compensation for its broadcast station signals from competing MVPDs than it could reasonably expect to achieve absent the transaction. The potential public interest harms that would result from such a strategy are substantial." (*News Corp. Order* ¶ 209, emphasis added)

Therefore, the *News Corp. Order* does not support ACA's claim that there is an imbalance in the current retransmission consent laws and that additional restrictions need to be placed on the other broadcast networks. Indeed, as Chairman Powell stated,

> One should not view [the Commission's] conditions regarding retransmission agreements or regional sports networks as anything other than a condition to mitigate a merger-specific harm identified in the record of this proceeding. It, especially, should not be interpreted as an industry-wide declaration of the Commission concerning the ongoing commercial disputes between MVPDs and broadcasters or regional and national sports programming networks. (*News Corp. Order*, Separate Statement of Chairman Michael K. Powell, footnote 2)